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No. 10-693

In the
Supreme Court of the United States

ERNST & YOUNG LLP, ET AL.,
Petitioners,

v.

SHARON P. CLARK, COMMISSIONER FOR THE KENTUCKY DEPARTMENT OF INSURANCE AND REHABILITATOR OF AIK COMP, ET AL.,
Respondents.

On Petition for Writ of Certiorari to the Supreme Court of Kentucky

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether Petitioner presents compelling reasons to grant the Petition where the Kentucky Supreme Court properly applied the McCarran–Ferguson Act, 15 U.S.C. § 1012(b), to prevent the Federal Arbitration Act, 9 U.S.C. § 2, from preempting state-insurance law where the state court's application of federal law does not conflict with a decision of this Court, does not conflict with a decision of a federal court of appeals, and does not implicate an important and unsettled question of federal law.

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OPINIONS BELOW

The Kentucky Supreme Court's opinion is now reported at 323 S.W.3d 682, and is reproduced in the Petitioners' Appendix.[1]

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

In addition to those listed by Petitioners, Kentucky Revised Statutes Sections 304.33-150 and 304.50-110 are involved in this case. These statutes are reproduced in full starting at App. 55b.

STATEMENT OF THE CASE

1. Kentucky employs a comprehensive statutory scheme for regulating the business of insurance. The scheme consists of fifty-two subtitles within Chapter 304 (the "Kentucky Insurance Code") of the Kentucky Revised Statutes governing virtually every conceivable aspect of the business of insurance. Among the statutory provisions is an exclusive-jurisdiction statute governing all matters related to an insurance company's rehabilitation. *See* Ky. Rev. Stat. Ann. § 304.33-040(3)(a).

Congress explicitly recognized, and indeed welcomed, the states' abilities to implement comprehensive insurance codes like Kentucky's by enacting the McCarran–Ferguson Act, 15 U.S.C.

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[1] The Petitioners' Appendix is cited as Pet. App. ___, the Petition for Writ of Certiorari as Pet. ___, and the Appendix attached hereto as App. ___.

§§ 1011–15. The McCarran–Ferguson Act establishes a policy of state primacy in regulating the business of insurance.

2. Kentucky employers must maintain workers' compensation insurance for their employees. Ky. Rev. Stat. Ann. § 342.340(1). Kentucky law allows employers to pool their liabilities and qualify as a group self-insurer. Ky. Rev. Stat. Ann. § 342.350(4). AIK Comp ("AIK") has been a group self-insurer for workers' compensation liabilities for Kentucky employers since 1979. AIK's policyholders (the group members of AIK) are jointly and severally bound to pay any deficits AIK incurs. *See* Ky. Rev. Stat. Ann. § 304.50-090(1).[2]

3. AIK began to incur substantial deficits sometime in the late 1990s. App. 6b, 21b. AIK did not learn of its perilous financial condition, however, until 2004. Pet. App. 6. Shortly thereafter, the Kentucky Commissioner of Insurance filed a petition to rehabilitate AIK pursuant to Kentucky's Insurers Rehabilitation and Liquidation Law ("IRLL"), Ky. Rev. Stat. Ann. §§ 304.33-010 to -600. The petition was filed in Franklin Circuit Court as required by Kentucky law. § 304.33-040(3)(a). The circuit court ordered AIK into rehabilitation in August 2004 and further ordered, pursuant to Section 304.33-150(1), the

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[2] This requirement was previously found at 803 Ky. Admin. Regs. 25:026 § 3(f). The Kentucky General Assembly reorganized the laws governing workers' compensation self-insurance groups in 2005. Unless otherwise noted, citations are to the current statutory sections.

Kentucky Commissioner of Insurance to serve as AIK's Rehabilitator.[3] App. 8b, 42b.

Special financial examinations ultimately revealed that AIK's liabilities exceeded its assets by over $90,000,000. Pet. App. 6. Because of this deficit, thousands of injured workers in Kentucky were and are at risk of having no workers' compensation insurance to cover medical costs and indemnity payments. Many AIK policyholders intervened in the rehabilitation action to protect their injured workers and their insurance coverage. Following negotiations among various AIK policyholders and the Rehabilitator, and a full hearing, the circuit court approved a Reorganization Plan and an Assessment Plan as mechanisms to fund the crippling deficit. App. 36b–37b.

Pursuant to the Assessment Plan, the Rehabilitator issued financial assessments to approximately 3,800 AIK policyholders to remedy the deficit. Pet. App. 6–7. The Rehabilitator, under the Franklin Circuit Court's supervision, acted expeditiously to recover funds necessary to protect injured workers dependent upon AIK for workers' compensation coverage. The primary goal of the rehabilitation efforts is to ensure the payment of injured-workers' claims, obligations which can remain for an indefinite amount of time under Kentucky law. *See* Ky. Rev. Stat. Ann. § 342.020(1).

AIK policyholders could partially satisfy their assessment obligation by executing promissory notes.

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[3] The Kentucky Commissioner of Insurance is currently Sharon P. Clark.

App. 23b. To forestall having to call those notes, and consistent with the IRLL, the court-approved Reorganization Plan requires the Rehabilitator to pursue claims against those third parties whose wrongdoing caused AIK's deficits. Pet. App. 7. Any damages recovered by the Rehabilitator should reduce or eliminate the need for future assessments, and may even enable the Rehabilitator to repay some previous assessments to the AIK group members. App. 26b, 36b.

4. Kentucky's Insurance Code requires workers' compensation self-insurance funds such as AIK to undergo annual audits by an independent certified public accountant. Ky. Rev. Stat. Ann. § 304.50-110(1).[4] The audit results must be filed with the Kentucky Commissioner of Insurance as an annual statement of financial condition. *Id.* The statutorily required audits are critical to Kentucky's ability to regulate the business of insurance and to protect injured workers. Petitioners Ernst & Young LLP and David S. Meyer (collectively, "Ernst & Young") performed the statutorily mandated audits for AIK from 1998 through 2002. Pet. App. 4–6. Ernst & Young's audits of AIK's financial statements were grossly inaccurate and negligently performed.

The Rehabilitator avers that, but for these inaccuracies, AIK could have adjusted its business practices and premiums to reduce or eliminate its deficits. App. 47b–51b. Alternatively, Kentucky regulators could have placed AIK into receivership

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[4] At the relevant times, Section 342.347(2) contained the audit requirement.

when its deficit was much smaller, thereby avoiding the overwhelming policyholder assessments. App. 47b, 49b. On this basis, and after investigation, the Rehabilitator filed suit against Ernst & Young. The claims were brought pursuant to express statutory authority:

> If the rehabilitator finds that there has been criminal or tortious conduct or breach of any contractual or fiduciary obligation detrimental to the insurer by any officer, manager, agent, employee, or other person, he or she may pursue all appropriate legal remedies on behalf of the insurer.

Ky. Rev. Stat. Ann. § 304.33-160(4).

The Rehabilitator's complaint alleges that Ernst & Young breached a variety of duties owed to AIK by producing inadequate and erroneous audits of financial statements. App. 47b–51b. Central to these claims are serious public-policy issues integral to Kentucky's interests both in regulating the business of insurance and in ensuring that Kentucky citizens injured in the workplace receive compensation. These claims were brought in Franklin Circuit Court pursuant to a Kentucky law requiring that court to supervise comprehensively not just AIK's rehabilitation, but also to "determine all matters in any way related to any delinquency proceeding under this subtitle, including but not limited to all disputes involving purported assets of the insurer." Ky. Rev. Stat. Ann. § 304.33-040(3)(a). Kentucky law recognizes the claims against Ernst & Young as an asset. *Button v. Drake*, 195 S.W.2d 66, 69 (Ky. 1946).

5. Ernst & Young moved the circuit court to compel arbitration pursuant to the Federal Arbitration Act (the "FAA"), 9 U.S.C. § 2, wrongly claiming that the private arbitration agreement between Ernst & Young and AIK bound the Rehabilitator. Pet. App. 31. The Franklin Circuit Court denied Ernst & Young's motion, citing the court's statutorily stated exclusive jurisdiction over any matter related to a delinquency proceeding. Pet. App. 32–34; *see* Ky. Rev. Stat. Ann. § 304.33-040(3)(a). The circuit court also ruled that the FAA is reverse-preempted by the McCarran–Ferguson Act, Pet. App. 39, and that the Rehabilitator (as a non-signatory) is not bound by the private agreement to arbitrate. Pet. App. 35–36. Clothed in the Commonwealth's police power, the Rehabilitator may revoke any private, pre-rehabilitation agreement to arbitrate. Pet. App. 38.

Ernst & Young appealed the circuit court's order denying the motion to compel arbitration. The case was transferred to the Kentucky Supreme Court, Pet. App. 27, which upheld the circuit court's denial of Ernst & Young's motion to compel arbitration based on McCarran–Ferguson reverse preemption. Pet. App. 19.

REASONS FOR DENYING THE PETITION

The question presented does not warrant this Court's review, the issue being neither disagreeable nor novel. All federal courts of appeals confronted with the question presented for review have decided in the same way as the unanimous Kentucky Supreme Court: the McCarran–Ferguson Act reverse preempts the FAA. Indeed, as discussed herein, the Court has twice considered, and twice denied, similar petitions

for writ of certiorari on virtually the same question and arguments as the instant case. *See Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277 (10th Cir. 1998), *cert. denied* 525 U.S. 1177 (1999); *Munich Am. Reinsurance Co. v. Crawford*, 141 F.3d 585 (5th Cir. 1998), *cert. denied*, 525 U.S. 1016 (1998).

Ernst & Young stretches cases well outside their factual bases and legal holdings to proffer a nonexistent split of authority, employs a claims-priority case not involving the FAA to allege a failure to follow this Court's precedent, and neglects to recognize that important state-law issues make this case an inappropriate one for review. Ernst & Young's argument essentially boils down to a contention that the Kentucky Supreme Court erred in applying previously established precedent. This Court grants certiorari in only those cases involving important public matters or where there is a "real and embarrassing conflict of opinion" between the circuit courts of appeal. *Layne & Bowler Corp. v. W. Well Works, Inc.*, 261 U.S. 387, 393 (1923). The Court looks for cases "involving unsettled questions of federal constitutional or statutory law of general interest." William H. Rehnquist, *The Supreme Court: How It Was, How It Is* 269 (1987). Ernst & Young's Petition presents neither a real or embarrassing conflict of opinion nor an unsettled question of federal law.

Ernst & Young is merely asking this Court to consider setting aside well-established law and find that the FAA preempts a state law that specifically regulates the business of insurance. There being no reasonable basis under this Court's Rule 10 for granting certiorari, the Petition should be denied.

I. THERE IS NO SPLIT OF AUTHORITY ON THE QUESTION ERNST & YOUNG PRESENTS.

A. The Portion of the Sixth Circuit Opinion that Other Circuit Courts Are Alleged to Have "Disagreed" with Differs in Key Respects to the Situation Here.

1. There is no split of authority on the question actually presented by the Petition. Every federal court of appeals to have considered whether the McCarran-Ferguson Act reverse preempts the FAA has answered in the affirmative. *See Standard Sec. Life Ins. Co. of N.Y. v. West*, 267 F.3d 821 (8th Cir. 2001) (per curiam); *Davister*, 152 F.3d 1277; *Munich*, 141 F.3d 585; *Stephens v. Am. Int'l Ins. Co.*, 66 F.3d 41 (2d Cir. 1995). Ernst & Young tellingly does not allege otherwise.

Ernst & Young attempts to manufacture a "split" by proffering *AmSouth Bank v. Dale*, 386 F.3d 763 (6th Cir. 2004), a case involving neither the FAA nor a state's statutory scheme for rehabilitating or liquidating an insolvent insurer. *AmSouth* was a diversity action in which the Sixth Circuit concluded that the McCarran–Ferguson Act did not reverse preempt declaratory judgment actions against insolvent insurance companies. The court based its reasoning, in part, on its determination that the threatened declaratory judgment actions against the insurance companies had only "an attenuated connection to regulating the business of insurance." *Id.* at 783. The primary issue in *AmSouth*, however, involved forum shopping between state and federal

courts. *AmSouth* had absolutely nothing to do with the FAA.

Ernst & Young uses *AmSouth* to recast the issue here from a showdown between the McCarran–Ferguson Act and the FAA to a showdown between the McCarran–Ferguson Act and "access to other forums," specifically federal courts. Pet. at 30. This sleight-of-hand does not manufacture the basic grounds for certiorari. Nonetheless, Ernst & Young heavily relies upon *AmSouth,* using it to underpin its arguments for an alleged circuit split on the question presented and for the Kentucky Supreme Court's alleged errors.

2. *AmSouth*'s facts and procedural posture are so distinguishable as to make it irrelevant. First, the instant case is not a declaratory judgment action; rather, it is an action against Ernst & Young to protect and secure assets for AIK's policyholders. Second, unlike *AmSouth*, the Rehabilitator's prosecution of this action and collection of assets directly advance the interests of the policyholders and injured workers dependent on AIK for medical and indemnity payments. They, and not shareholders or outsiders, are the sole beneficiaries of this action. Third, this action explicitly derives from Kentucky's statutory scheme which regulates the business of insurance. This action is not a garden-variety common-law-damages suit tangentially related to Kentucky's IRLL. Fourth, this action was properly filed in the Franklin Circuit Court pursuant to the exclusive-jurisdiction provision set forth in Kentucky's IRLL. A similar exclusive-jurisdiction provision was not at issue in *AmSouth*. Moreover, the claims in this case, unlike

those in *AmSouth*, arise from the rehabilitation orders issued pursuant to the IRLL.

Finally, *AmSouth* did not involve Ohio's statutory scheme relating to insurer liquidations. In fact, *AmSouth*'s discussion of McCarran–Ferguson did not describe or even reference state statutory schemes. Although cases construing Ohio's statutory scheme were cited, Ohio's statutory scheme was not at issue. In short, *AmSouth* is inapposite.

3. Ernst & Young compares the allegedly "attenuated" connection between the regulation of insurance and the Rehabilitator's claims against Ernst & Young to the "attenuated" connection with the insurance issues in *AmSouth*. Pet. 27–28. But the attenuation in *AmSouth* derived from the case being only a declaratory judgment action. 386 F.3d at 783 ("Here, of course, the Banks seek only declaratory judgment, based in turn on a threatened ordinary common-law action against them, and the assets of the insurance companies are up for grabs only in that attenuated fashion.").

This case is no declaratory judgment action. It is a coercive action to recover damages for negligent performance of statutorily required audits—audits required by Kentucky's insurance law as an express part of the regulation of the business of insurance. Or, as the Kentucky Supreme Court wrote:

> We can hardly overstate the degree to which the regulation of insurance permeates this controversy. The very claims which Ernst & Young would take to arbitration arise directly out of Kentucky's intense interest in the

> regulation of worker's compensation insurance. The audits that form the core of the Rehabilitator's claims were performed by Ernst & Young for AIK Comp to comply with state insurance regulations which include a review of such audits by the state's insurance commissioner to monitor the solvency of AIK Comp. *The IRLL is itself the ultimate measure of the state's regulation of the insurance business: the take-over of a failing insurance company.*

Pet. App. 12 (emphasis added). There is nothing "attenuated" about the manner in which assets are at issue here.

The Rehabilitator's ability to bring claims against Ernst & Young is specifically derived from the Kentucky Insurance Code and would not exist otherwise. *AmSouth* recognizes the importance of this distinction, noting that "[t]his dispute involves the Receivers' attempt to recover money in an ordinary common-law-damages suit; the Banks do not here attempt to disrupt a coherent state scheme in favor of enriching their own pockets." *AmSouth*, 386 F.3d at 780.

In *AmSouth*, no state statutory provision created duties or liabilities upon banks in handling transactions with insurance companies. Contrast that with Kentucky's statutory audit requirements. AIK, and all other insurers doing business in Kentucky, must procure audits from independent third parties each year that demonstrate the insurer's financial solvency. Ky. Rev. Stat. Ann. § 304.50-110(1).

Furthermore, Kentucky's Insurance Code prohibits inaccurate or misleading financial statements. *See* Ky. Rev. Stat. Ann. § 304.12-040; § 304.50-110(5). The Rehabilitator is statutorily required to pursue claims against any person who tortiously performed tasks required by the Kentucky Insurance Code. *See* § 304.33-160(4); Pet. App. 7. The Rehabilitator's claims must be brought in a specific state court, the Franklin Circuit Court. *See* § 304.33-040(3)(a).

Ultimately, *AmSouth* is useless to Ernst & Young. *AmSouth* announces no disagreement with other circuits on any relevant McCarran–Ferguson issue presented here. It takes no issue whatsoever with other circuit courts of appeals that have specifically held that the McCarran–Ferguson Act reverse preempts the FAA. Indeed, *AmSouth* is silent with regard to the relationship between the McCarran–Ferguson Act and the FAA. *AmSouth* applies only when there is an "attenuated" relationship between the claims at issue and the state insurance law sought to be preempted. Ernst & Young cannot show such "attenuation," regardless of how frequently it labels itself as a mere "third party," dismisses the Rehabilitator's claims as "garden variety" or "incidental," or refers to the relationship of its audits with Kentucky insurance law as "attenuated." The stubborn facts remain and defy such facile and misleading characterizations. The Kentucky Supreme Court correctly found that the Rehabilitator's claims are "an essential component of AIK Comp's rehabilitation." Pet. App. 18. There is nothing "attenuated" about it.

B. The Other Cases Cited by Ernst & Young that Allegedly Reflect a Circuit Split Are Not on Point.

The other cases cited by Ernst & Young for the alleged circuit split are equally unavailing. Ernst & Young concedes that *Garcia v. Island Program Designer, Inc.*, 4 F.3d 57 (1st Cir. 1993), is not factually applicable to this case. Pet. 33. Nonetheless, Ernst & Young cites the case for its "reasoning." But reasoning does not create split authority—only holdings do. Furthermore, the First Circuit has itself recognized the criticism *Garcia* has undergone. *See Ruthardt v. United States*, 303 F.3d 375, 384–86 (1st Cir. 2002).

The final case Ernst & Young cites as creating a split in authority resolved an issue of federal court jurisdiction. In *Gross v. Weingarten*, 217 F.3d 208 (4th Cir. 2000), the court held that the McCarran–Ferguson Act does not reverse preempt the federal diversity jurisdiction statute, but noted that on certain matters federal courts should avoid disrupting "'state efforts to establish a coherent policy with respect to a matter of substantial public concern'" by exercising restraint through abstention. *Id.* at 222–23 (quoting *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 491 U.S. 350, 361 (1989)). Once again, neither arbitration nor the FAA was at issue. Ernst & Young cites no case that resolves the exact question presented other than in the Rehabilitator's favor.

None of *AmSouth*, *Gross*, or *Garcia* involved workers' compensation group self-insurance companies, meaning any benefits sought in those cases would redound to shareholders. This distinction is crucial because it removes any "attenuation." Here,

policyholders and injured workers ultimately receive any benefit gained. Thus, the applicability of cases like *AmSouth* and *Garcia* that relied on such attenuated circumstances is undermined. *See AmSouth*, 386 F.3d at 783; *Garcia*, 4 F.3d at 62. This Court should deny review where no lower courts express diverging views on the narrow question presented.

II. THE KENTUCKY SUPREME COURT'S ANALYSIS OF THE MCCARRAN-FERGUSON ACT'S REACH IS FULLY CONSISTENT WITH THIS COURT'S PRECEDENTS.

Ernst & Young argues that the Kentucky Supreme Court failed to comply with this Court's reasoning in *United States Department of Treasury v. Fabe*, 508 U.S. 491 (1993). Ernst & Young's new-found reliance upon *Fabe* is an interesting tactic. Ernst & Young did not argue *Fabe* in its briefs to the Kentucky Supreme Court, and, as it states in its Petition, specifically raised and primarily argued *Fabe* for the first time during oral arguments. *See* Pet. 10 (referencing Ernst & Young's primary argument during briefing); *see also Hormel v. Helvering*, 312 U.S. 552, 556 (1941) ("Ordinarily an appellate court does not give consideration to issues not raised below."). Nevertheless, the Kentucky Supreme Court's decision is fully consistent with this Court's reasoning in *Fabe*.

A. *Fabe* Is a Claims-Priority Case that Does Not Involve the FAA.

In *Fabe*, the Court considered a conflict between an Ohio statute conferring only fifth priority upon claims

of the United States in proceedings to liquidate an insolvent insurer and a federal statute according first priority to the United States. 508 U.S. at 493. The Court held that the McCarran-Ferguson Act applied and prevented federal preemption to the extent that the Ohio statute protects policyholders. *Id.* The Court further found that the "broad category of laws enacted 'for the purpose of regulating the business of insurance' . . . necessarily encompasses more than just the 'business of insurance.'" *Id.* at 505 (internal citation omitted). Ernst & Young conveniently ignores this holding in its Petition.

Fabe did not involve the relationship between the McCarran–Ferguson Act and the FAA. *Fabe* is merely a claims-priority case setting forth an analysis consistent with the Kentucky Supreme Court's opinion. As set forth herein, *Fabe* hurts, rather than helps, Ernst & Young.

Section 2(b) of the McCarran–Ferguson Act provides, in pertinent part, that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance." 15 U.S.C. § 1012(b). In reliance upon that language, *Fabe* sets forth a three-part test for determining if the McCarran–Ferguson Act should be applied: (1) does the federal statute at issue, i.e., the FAA, "specifically relate to the business of insurance"; (2) was the state statute enacted "for the purpose of regulating the business of insurance"; and (3) would application of the federal statute "impair, invalidate, or supersede" the state statute. 508 U.S. at 500–01.

There is no dispute here as to the first part of the test because the FAA does not specifically relate to the business of insurance. Ernst & Young wrongly contends that the Kentucky Supreme Court erred in its analysis of parts two and three of the test set forth in *Fabe*.

B. According Preemptive Effect to the FAA Would Invalidate, Impair, and Supersede Kentucky Laws Regulating the Business of Insurance in Violation of the McCarran-Ferguson Act.

1. The Kentucky Supreme Court correctly found AIK's rehabilitation to be proceeding under laws enacted to regulate the business of insurance. In *Fabe*, this Court held that state laws governing even insurance company *liquidation*, "at which point the insurance company no longer exists," are enacted "for the purpose of regulating the business of insurance." *Id.* at 505–06. If insurer liquidation laws regulate the business of insurance, then surely insurer *rehabilitation* laws do. Even the dissenters in *Fabe* would agree. The dissent recognized policyholders' "vital interest in the financial strength and solvency of their insurers," but concluded that state priority laws in liquidation proceedings do not regulate the "business of insurance" simply because it is "too late" at the liquidation stage to "increase the reliability or the solvency of the insurer." *Id.* at 513 (Kennedy, J., dissenting). The dissent's reasoning underscores the key difference here. It is not too late at the rehabilitation stage to "increase the reliability or the solvency of the insurer" and to protect the policyholders' "vital interest" in AIK's "financial

strength and solvency." The Rehabilitator's claims against Ernst & Young are critical to the "financial strength," "solvency," and "reliability" of AIK and central to the proceedings Kentucky law comprehensively assigns to the Franklin Circuit Court. Both *Fabe*'s majority opinion and dissent support McCarran–Ferguson reverse preemption of the FAA.

2. Next, the McCarran–Ferguson Act applies because preemption by the FAA would "invalidate," "impair," and "supersede" Kentucky's rehabilitation law. Removing key issues from the Franklin Circuit Court and assigning them to an arbitrator is clearly at odds with Kentucky law. This case therefore meets the test set forth in *Humana Inc. v. Forsyth,* 525 U.S. 299 (1999), for the meaning of the words "invalidate, impair, or supersede" as used in the McCarran–Ferguson Act, and the Kentucky Supreme Court properly framed (and answered) the question before it under the *Forsyth* framework.

Forsyth teaches that preemption of state insurance law is permitted only if the preempting "federal law does not directly conflict with state regulation, and when application of the federal law would not frustrate any declared state policy or interfere with a state's administrative scheme." *Id.* at 310. Here, giving preemptive effect to the FAA would "frustrate" the "declared state policy" and "interfere with a State's administrative scheme" because it would force the Rehabilitator to take her claims from the statutorily mandated court-rehabilitation proceedings and bring them instead before an arbitrator. The Rehabilitator exercises the Commonwealth's police power in this regard. *See Minor v. Stephens,* 898 S.W.2d 71, 78 (Ky. 1995). Subordinating that authority to a private

contract, in direct contradiction to the express terms of Section 304.33-010(6), "interferes" with the Commonwealth's "declared" policy and would seriously undercut its regulatory scheme. An arbitrator, rather than the rehabilitation court, would determine key issues related to the deceptive audits that led to AIK's collapse; this substitution directly contradicts the express terms of Section 304.33-040(3)(a). Removing issues from rehabilitation proceedings, particularly if the issues to be removed are as vital as those at issue here, "impairs" state law requiring comprehensive proceedings under the supervision of a single managing court. *See, e.g.*, *Davister*, 152 F.3d at 1281.

The Kentucky Supreme Court's decision is solidly grounded in applicable law. The FAA directly conflicts with Kentucky laws governing comprehensive insurer rehabilitation proceedings. The McCarran–Ferguson Act protects the Kentucky Insurance Code.

C. Ernst & Young's Claim that the Kentucky Supreme Court's Decision Expands the McCarran–Ferguson Act Beyond Limits Set by this Court Mischaracterizes the Law, the Nature of Its Dispute with the Rehabilitator, and the Kentucky Supreme Court's Analysis.

Ernst & Young asserts that the Kentucky Supreme Court failed to comply with *Fabe* in that it conducted the reverse-preemption analysis by focusing only "on the Liquidation Law as a whole, rather than the particular application of the sections at issue." Pet. 17. Only by employing this overbroad focus, Ernst & Young contends, was the Kentucky Supreme Court

able "to hold that its anti-arbitration implementation of the exclusive-jurisdiction provision could be applied to this garden-variety tort dispute between the insurer and a third party." Pet. 17. Ernst & Young errs in a variety of ways.

1. Ernst & Young's characterization of this dispute as "garden variety" and of itself as a mere "third party" otherwise not implicated in the rehabilitation is specious (as if it had been selling office supplies rather than providing audit reports to state regulators). Ernst & Young simply cannot create any meaningful distance between its role as auditor and Kentucky's regulation of the business of insurance. Indeed, Ernst & Young previously conceded this very point to the Kentucky Supreme Court.[5]

2. Even a cursory review of the Kentucky Supreme Court's opinion proves that it did look at the "particular application" of the Kentucky insurance law sections that were directly "at issue," as well as the specific ways that Kentucky insurance law would be invalidated, impaired, and superseded by removing the Rehabilitator's action against Ernst & Young from the rehabilitation proceeding. The court noted that Section 304.33-010(6) expressly subordinates "any contractual provision" in conflict with Kentucky's

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[5] As the Kentucky Supreme Court explained, Ernst & Young insisted that its audits were "matters 'relating to Kentucky's Workers' Compensation Statutes'" when the members signed agreements making AIK their "agent." Pet. App. 23–24. Thus, Ernst & Young strongly embraced the close relationship of its audits to Kentucky insurance law when convenient, but now revises its characterization of that relationship for purposes of its Petition.

insurance law "if there is a delinquency proceeding," and explained that here "the Rehabilitator has been charged to 'pursue all appropriate legal remedies on behalf of the insurer.'" Pet. App. 17. The court further explained that Ernst & Young's involvement is integral to Kentucky's regulation of insurance: "[T]he Rehabilitator's claims against Ernst & Young are an essential component of AIK Comp's rehabilitation." Pet. App. 18. The claims "fall squarely within the scope of KRS 304.33-040(3)(a), as 'matters . . . relating to [a] delinquency proceeding under this subtitle, including . . . all disputes involving purported assets of the insurer,' and therefore, under KRS 304.33-010(6) remain within the exclusive jurisdiction of the Franklin Circuit Court." Pet. App. 18.

Having established a conflict between application of the FAA and Kentucky law regulating the business of insurance, the court then analyzed the specific ways that Kentucky law would be frustrated by FAA preemption. Removing the Rehabilitator's claims against Ernst & Young from the rehabilitation proceedings would eviscerate the trial court's "broad discretion to decide all issues pertaining to pre-hearing procedures, including discovery, all issues of substantive law, and all evidentiary matters." Pet. App. 18. Kentucky's General Assembly did not contemplate "[s]uch a substantial reduction of the court's role" in "issues critical to the state's interest in the rehabilitation or liquidation of the insurance company." Pet. App. 19. Having carefully analyzed the *specific* effects of the *specific* conflict between the FAA and the sections of the Kentucky Insurance Code sought to be preempted, the Kentucky Supreme Court concluded that the FAA's "preference for arbitration conflicts with, and impairs, the IRLL's grant of broad

and exclusive jurisdiction to the Franklin Circuit Court." Pet. App. 19. Therefore, McCarran–Ferguson reverse preemption applied.

3. Ernst & Young ignores, and asks this Court to ignore, the Kentucky Supreme Court's detailed analysis of the specific impairment to Kentucky insurance law that would result from FAA preemption. Instead, Ernst & Young asserts that "the Kentucky Supreme Court focused on the purpose of the Liquidation Law as a whole — rather than the specific provisions of that law which would be 'invalidate[d], impair[ed], or supersede[d]' by the FAA." Pet. 16 (alterations in original). Ernst & Young constructs an argument on this erroneous assertion that the Kentucky Supreme Court's decision conflicts with *Fabe*.

Having set up its straw man, Ernst & Young proceeds to demolish it, devoting page after page to its argument that *Fabe* requires consideration of the specific effect the proposed preemption would have on specific provisions of that law.[6] This is, of course, simply another way of saying that the McCarran–Ferguson Act requires a showing that state law regulating the business of insurance would be invalidated, impaired, or superseded if preempted. *See* 15 U.S.C. § 1012(b). But it is certainly not accurate to compare the partial preemption approved in *Fabe* to the case at bar. Partial preemption of the Ohio

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[6] The Court did engage in statutory parsing in *Fabe*. Nonetheless, "the Court stopped short of directing that this approach be taken in every case." *Munich*, 141 F.3d at 592 (citing *Fabe*, 508 U.S. at 509 n.8).

priority statute at issue in *Fabe* did not "impair" Ohio's regulation of the business of insurance for the simple reason that the Ohio statutory subsection at issue had nothing to do with the state's interest in regulating the "business of insurance." On the other hand, consolidating all rehabilitation matters in Franklin Circuit Court, particularly matters as vital as Ernst & Young's erroneous audits, directly advances the state's interest in regulating the business of insurance.

In fact, *Fabe* damages Ernst & Young's Petition. After all, the *Fabe* Court protected every portion of Ohio's priority statute that it reasonably could. Under *Fabe*, a state statute regulates "the business of insurance" if it "serves to ensure that, if possible, policyholders ultimately will receive payment on their claims." 508 U.S. at 506. As here, *Fabe* upheld by reverse preemption state preferences for policyholders and liquidation expenses because they "*further the goal of protecting policyholders.*" *Id.* at 509 (emphasis added).

That is precisely what the Kentucky statutes under attack here do: protect policyholders and ensure payment of policyholders' and injured-workers' claims. The clarity of that goal is underscored where, as here, there are no shareholders, but only members who self-insure. Any benefits gained from the suit in Franklin Circuit Court will inure solely to AIK's policyholders and the injured workers dependent upon a solvent AIK.[7]

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[7] Kentucky's workers' compensation statute "is one of the more liberal among the various states in that it obligates the employer for full payment of medical and related benefits." Norman E.

Indeed, this action directly advances the interests of insureds, policyholders, and the state on numerous levels. The IRLL itself specifies the purposes of the code: "enhanced efficiency and economy of liquidation" through consolidation of proceedings in a single court "so as to avoid divergent rulings by a multiplicity of judicial tribunals and through clarification and specification of the law," Ky. Rev. Stat. Ann. § 304.33-010(4)(c); "[r]egulation of the insurance business" by imposing substantive rules, § 304.33-010(4)(f); and provision of a "comprehensive scheme for the supervision, rehabilitation, and liquidation of insurance companies *and* those subject to this subtitle as part of the regulation of the business of insurance," § 304.33-010(4)(g) (emphasis added). The Rehabilitator's claims, placed under the Franklin Circuit Court's comprehensive management and sole jurisdiction, advance these purposes.

Ernst & Young's argument rests on convincing this Court of two things: (1) that the Kentucky Supreme Court did not perform the reverse-preemption analysis at a focused level on the particular statutes affected, thereby violating *Fabe;* and (2) that Ernst & Young's role in the financial collapse of AIK is so peripheral to the rehabilitation proceedings that the court erred in applying the analysis that pertains when the statute was enacted "for the purpose of regulating the business of insurance." Ernst & Young is wrong on both counts.

Harned, *Kentucky Workers' Compensation* § 2.01 (3d ed. 2004). Kentucky imposes no time or amount limitation on the payment of medical benefits, along with providing disability payments, lost-income benefits, and death benefits. *See* Ky. Rev. Stat. Ann. § 342.020; § 342.040; § 342.160; § 342.730.

III. THE KENTUCKY SUPREME COURT'S DECISION SQUARES WITH OTHER COURTS THAT HAVE ADDRESSED REVERSE PREEMPTION OF THE FAA.

A. The Circuits Are in Accord with the Kentucky Supreme Court.

Numerous courts have rejected FAA preemption under the circumstances here. These courts have emphasized that comprehensive proceedings with exclusive jurisdiction in a single state court advance policyholders' interests. *See, e.g.*, *Davister*, 152 F.3d at 1281; *Munich*, 141 F.3d at 593.

1. For instance, in *Munich*, a creditor-reinsurer sued the liquidator of an insolvent insurer over an alleged debt. *See* 141 F.3d at 587. The Oklahoma Insurance Commissioner, serving as liquidator, would not submit to arbitration with the creditor-reinsurer. The Fifth Circuit refused to compel arbitration, holding that the state insurance liquidation act reverse preempted the FAA. *See id.* Specifically, the Fifth Circuit applied *Fabe* and held that state laws granting exclusive jurisdiction to state courts in insurance-insolvency matters regulate the business of insurance. *Id.* at 592–93. Consolidating all claims against the insolvent insurer's limited assets in one court prevents the wasting of estate funds that necessarily would occur if the liquidator was forced to defend different suits brought by different claimants in different forums. *Id.* at 593. In sum, state court exclusive jurisdiction is "reasonably necessary" to advance the goal of protecting policyholders. *See id.* at 594.

The creditor-reinsurer in *Munich* filed a petition for a writ of certiorari. This Court denied that petition. 525 U.S. 1016. Ernst & Young has asserted virtually the same issue and alleged the same conflicts as the petitioner in *Munich*.

2. Similarly, in *Davister*, the Tenth Circuit applied the three-part test set forth in *Fabe* to uphold the United States District Court for Utah's decision not to compel arbitration of a dispute involving an insurer in liquidation. *See* 152 F.3d at 1281–82. The aggrieved party in that case also filed a petition for a writ of certiorari with this Court. The Court also denied that petition. 525 U.S. 1177.

The *Munich* and *Davister* courts both recognized that, by definition, an insurance company in rehabilitation or liquidation has little cash to spare. Litigation in multiple forums is needless and expends precious resources that could otherwise be used to strengthen the insurer's solvency or to pay claims. *Davister*, 152 F.3d at 1281; *Munich*, 141 F.3d at 593. "Consolidation also eliminates the risk of conflicting rulings, piecemeal litigation of claims, and unequal treatment of claimants, all of which are of particular interest to insurance companies and policyholders, who are often relying on policies with the same or similar provisions." *Munich*, 141 F.3d at 593.

3. Policyholders also benefit from the openness and publicity surrounding court proceedings, as well as extended discovery. *See* Susan Randall, *Mandatory Arbitration in Insurance Disputes: Inverse Preemption of the Federal Arbitration Act*, 11 Conn. Ins. L.J. 253, 258 (2005). Arbitration often occurs behind closed doors and the resulting decision is made confidential.

Id. This should not be so in a matter of such public interest. AIK provided not just insurance; it provided workers' compensation insurance. Workers' compensation insurance serves a key public policy by enforcing a trade-off between employer and employee in exchange for stability and confidence. *See Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co.*, 547 U.S. 651, 655 (2006) (discussing the trade-off). Open court proceedings that fully display negligent practices decrease the likelihood, if only from a public-relations perspective, of future transgressions. Policyholders benefit from the cleansing effect of such sunshine and the evidentiary and civil rules provided by litigation in a court. Randall, *supra*, at 258. Stripping the Franklin Circuit Court of its exclusive jurisdiction over this matter in favor of arbitration would prevent this result.

Finally, Kentucky's exclusive-jurisdiction provision regulates the business of insurance in two other ways. First, it transfers or spreads risks by "introducing the possibility of jury verdicts into the process for resolving disputed claims."[8] *West*, 267 F.3d at 824; *McKnight v. Chi. Title Ins. Co.*, 358 F.3d 854, 858 (11th Cir. 2004) (per curiam) (quoting *West*). Full discovery practice that reveals the legal issues and

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[8] The Center for Audit Quality's amicus brief alludes to "concerns of state parochialism." Brief for The Center for Audit Quality as Amicus Curiae Supporting Petitioner 16. The Center fails to recognize that the Franklin Circuit Court (located in Kentucky's capital city) is Kentucky's equivalent of the United States District Court for the District of Columbia. The Franklin Circuit Court rules for and against the Commonwealth on a regular basis. Furthermore, post-trial motion practice and appeals provide remedies for these illusory and insulting concerns.

business decisions that led to financial disaster, followed by a jury trial on all relevant claims, increases the likelihood that policyholder claims will be paid to a degree that arbitration cannot match. *Cf. Fabe*, 508 U.S. at 505–06 (protecting a statute from FAA preemption "to the extent that it serves to ensure that, if possible, policyholders will ultimately receive payment on their claims"); Randall, *supra*, at 258.

Second, the statute "expressly invalidat[es] the parties' chosen mode of contract enforcement." *McKnight*, 358 F.3d at 858; *see also West*, 267 F.3d at 824. McCarran–Ferguson allows states to deny the deployment of smokescreens to hide complicity. The Kentucky legislature invoked its right under the McCarran–Ferguson Act to require that claims against a tortfeasor be presented in open court when the tortfeasor's actions allegedly contributed to an insurer's demise. This election of rights is particularly relevant where the insurer's downfall was allegedly caused by the negligent performance of a statutorily required duty. Ernst & Young cannot hide behind the secrecy of arbitration proceedings against a party that never agreed to arbitrate. These accepted measures for regulating the business of insurance support the Kentucky Supreme Court's holding.

B. The Second Circuit Previously Held Kentucky's IRLL Regulates the Business of Insurance.

Ernst & Young challenges portions of the Kentucky IRLL that previously withstood attack in the Second

Circuit.[9] In *Stephens*, the Second Circuit held that a Kentucky statute prohibiting arbitration of claims involving insurers in rehabilitation or liquidation reverse preempted the FAA. 66 F.3d at 42. The Second Circuit specifically rejected the claim that Kentucky's anti-arbitration provisions did not regulate the business of insurance after applying the principles of *Fabe, Union Labor Life Insurance Co. v. Pireno*, 458 U.S. 119 (1982), and *Group Life & Health Insurance Co. v. Royal Drug Co.*, 440 U.S. 205 (1979). *See Stephens*, 66 F.3d at 45. Rather, the court wrote that the Kentucky IRLL "'protects' policyholders . . . by assuring that an insolvent insurer will be liquidated in an orderly and predictable manner and the anti-arbitration provision is simply one piece of that mechanism." *Id.* at 45. Contrary to Ernst & Young's assertions, nowhere does *Stephens* indicate that it is bound to its insurer-versus-reinsurer facts. Pet. 31. The *Stephens* court instead analogized the insurer-reinsurer relationship to that between an insurer and policyholder and then applied the generally applicable rules for determining whether a statute regulates the business of insurance. *Stephens*, 66 F.3d at 44.

Like *Stephens*, the exclusive-jurisdiction provision here protects policyholders by ensuring "orderly and predictable" proceedings for insolvent insurers. Bankruptcy protection is unavailable for insurance

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[9] The Kentucky General Assembly amended the challenged statute in the wake of *Stephens v. Am. Int'l Ins. Co.*, 66 F.3d 41 (2d Cir. 1995), to recognize that agreements between an insurer and reinsurer may be submitted to arbitration. *See* Ky. Rev. Stat. Ann. § 304.33-101(6); 1996 Ky. Acts ch. 183, § 1. As Ernst & Young notes, however, the "change is immaterial here." Pet. 31 n.1.

companies. *Fabe*, 508 U.S. at 519 (Kennedy, J., dissenting). Instead, state law protects insolvent insurers by consolidating all actions related to rehabilitation or liquidation in a single court. *See Munich*, 141 F.3d at 593 ("The experience of the federal bankruptcy courts, which evidences the importance of consolidating all of the assets of an insolvent company and the claims against those assets in a single forum, supports the legitimacy of the Oklahoma scheme in protecting the interests of policyholders."). The McCarran–Ferguson Act places the onus on states to provide such protections, and, as *Stephens* demonstrates, Kentucky accepted the responsibility.

C. The Claims Against Ernst & Young Concern the Business of Insurance, a Subject of State Regulation Protected by the McCarran–Ferguson Act.

1. This Court has recognized that the McCarran–Ferguson Act made the "business of insurance" a subject of state regulation. In *American Insurance Ass'n v. Garamendi*, 539 U.S. 396, 427–28 (2003), the Court wrote that "'[t]he business of insurance' shall be recognized as a subject of state regulation, which will be good against preemption by federal legislation unless that legislation 'specifically relates to the business of insurance.'" (Internal citations omitted.)

Congress has unquestionably left the regulation of the "business of insurance" to the states. State statutes aimed at "protecting or regulating" the relationship between insurer and insured, either

"directly or indirectly, are laws regulating the 'business of insurance.'" *See SEC v. Nat'l Sec., Inc.*, 393 U.S. 453, 460 (1969). AIK was in the business of insurance;[10] Kentucky's Insurance Code regulates the business of insurance; Kentucky's statutes and regulations requiring insurers to file audit reports with state regulators protects insureds; and, now that AIK is in rehabilitation, Kentucky's IRLL protects the interests of insureds, creditors, and the general public.

However the Court looks at it, AIK was and is in the business of insurance, and Ernst & Young's audit of AIK was an integral and required part of Kentucky's comprehensive statutory scheme to regulate and to protect the relationship between the insurer and insured. *See* Ky. Rev. Stat. Ann. § 304.33-010(5) ("All persons who voluntarily transact business with an insurer which is subsequently the subject of a delinquency proceeding under this subtitle shall be conclusively presumed to have transacted business with the intent that the provisions of this subtitle would control if there is any delinquency proceeding in this state.").

Ernst & Young's transparent attempt to recast itself as something akin to a third-party bystander must fail. The Commonwealth of Kentucky has squarely addressed all of the issues involved in the regulation and rehabilitation of a self-insurance fund like AIK, including the audits of those funds. Ernst & Young has conceded the close relationship between its

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[10] The Sixth Circuit has specifically held that AIK provided insurance to its members. *See Associated Indus. of Ky., Inc. v. U.S. Liab. Ins. Group*, 531 F.3d 462, 467 (6th Cir. 2008).

auditing function and Kentucky insurance law. There is simply no way to separate Ernst & Young's audit of AIK from the state-regulated "business of insurance."

2. Of course there are cases where a state law was preempted because it, unlike Kentucky's auditing and rehabilitation laws, was not enacted for the purpose of regulating the "business of insurance." There are also cases where state insurance law did not conflict with the federal law sought to be reverse preempted and was not, as a result, impaired. Ernst & Young cites such cases, including *Fabe*. Ernst & Young also cites *Royal Drug*, an antitrust case alleging that an insurer and three pharmacies indulged in price-fixing of drugs and group boycott. *See* 440 U.S. at 207. Ernst & Young discusses both at length despite the lack of relevance. Neither *Royal Drug* nor *Fabe* provides the slightest support to Ernst & Young's contention that its role here is removed from the state's regulation of the business of insurance. The same is true of *Pireno*, also cited by Ernst & Young. *Pireno*, like *Royal Drug*, involved Sherman Act antitrust price-fixing claims and therefore an entirely different provision of the McCarran–Ferguson Act than that at issue here. *Pireno*, 458 U.S. at 122. Moreover, the Court in *Fabe* expressly cautioned against reading these cases as broadly as Ernst & Young does:

> But we do not read *Pireno* to suggest that the business of insurance is confined entirely to the writing of insurance contracts, as opposed to their performance. *Pireno* and *Royal Drug* held only that "ancillary activities" that do not affect performance of the insurance contract or enforcement of contractual obligations do not

> enjoy the antitrust exemption for laws regulating the "business of insurance."

Fabe, 508 U.S. at 503.

Ernst & Young's role in this rehabilitation is not merely "ancillary." The Kentucky Supreme Court correctly, and soundly, rebuffed Ernst & Young's argument that it is:

> Far from being just a coincidental aspect of a "garden variety" claim, AIK Comp's insolvency was allegedly caused by Ernst & Young's audits which masked AIK Comp's true financial condition. Under the Reorganization Plan approved by the Franklin Circuit Court, the Rehabilitator's claims against Ernst & Young are an essential component of AIK Comp's rehabilitation.

Pet. App. 17–18.

The Kentucky Supreme Court's reasoning on the McCarran–Ferguson Act issue is impeccable, and its compliance with applicable law obvious. There is no reason for this Court to review the Kentucky Supreme Court's rejection of Ernst & Young's attempt to distance itself from Kentucky's efforts to rehabilitate AIK. The Petition should be denied.

IV. THIS CASE IS AN IMPROPER VEHICLE TO RESOLVE ANY PERCEIVED DISAGREEMENT.

Certiorari is improvident where, as here, state-law issues may prevent the Court from reaching the

question or render the Court's decision moot as to the parties. In other words, granting the Petition will not change the ultimate outcome.

1. The Kentucky Supreme Court specifically focused its opinion on the McCarran–Ferguson reverse-preemption issue. The court did not consider other issues that were decided below, then briefed and argued before the court. Therefore, this is not currently an independent and adequate state grounds case because no "plain statement" exists. *See Michigan v. Long*, 463 U.S. 1032, 1041 (1983).

Nonetheless, the Franklin Circuit Court's opinion and order did address all issues brought before that court. Predominant among the circuit court's holdings is that any alleged arbitration agreement is not enforceable against the Rehabilitator because she did not sign it and because there are no grounds to support enforcement against her. *See* Pet. App. 35–36. ("There exist no facts which support commonly recognized reasons for applying a contractual agreement to a nonsignatory."). In *Arthur Anderson LLP v. Carlisle*, 129 S. Ct. 1896, 1902 (2009), this Court reiterated that state law governs the enforceability of agreements to arbitrate, including alleged agreements with nonparties. *See also Perry v. Thomas*, 482 U.S. 483, 492 n.9 (1987) (noting that "state law, whether of legislative or judicial origin, is applicable *if* that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally" (emphasis in original)); *First Options of Chi., Inc. v. Kaplan*, 514 U.S. 938, 944 (1995) ("When deciding whether the parties agreed to arbitrate a certain matter (including arbitrability), courts generally . . . should apply ordinary state-law principles that govern

the formation of contracts."). That principle applies here; thus, without a valid arbitration agreement, no federal question exists.

Kentucky law holds that the Rehabilitator is not bound by the arbitration agreement because she did not sign it. *See, e.g.*, *Olshan Foundation Repair and Waterproofing v. Otto*, 276 S.W.3d 827, 831 (Ky. Ct. App. 2009). If this Court grants certiorari and reverses, the issue would be taken up on remand, decided in the Rehabilitator's favor, and Ernst & Young would have suffered a hollow victory.

2. None of the theories recognized for binding nonsignatories to arbitration agreements justify binding the Rehabilitator here. *See, e.g.*, *Carlisle*, 129 S. Ct. at 1902 (recognizing the theories as incorporation by reference, assumption, agency, veil-piercing / alter ego, third-party beneficiary theories, and estoppel) (citing 21 Richard Lord, *Williston on Contracts* § 57:19 (4th ed. 2001)). The Rehabilitator never entered into a separate contractual relationship with Ernst & Young or indicated a willingness to arbitrate. The Rehabilitator cannot be bound under an agency theory because the arbitration agreement was entered into well before AIK's rehabilitation began. *Benjamin v. Pipoly*, 800 N.E.2d 50, 59 (Ohio Ct. App. 2003), stands for this proposition, holding that where the state-appointed receiver did not sign the agreement to arbitrate, it could not be enforced against her.

The court in *Benjamin* reasoned that a receiver "must have freedom of action to do those acts most beneficial in achieving her objectives." *Id.* at 58. Accordingly, the court held that a receiver

> may affirm or disavow the rights and obligations of the interest with which she is charged, and it would be inconsistent to compel arbitration against her when such an obligation predates her appointment.
>
> Thus we hold that when a liquidator is appointed by court order, as in the instant case, she is not automatically bound by the pre-appointment contractual obligations of the insurer.

Id. at 58–59.

The Kentucky Supreme Court has likewise articulated such a policy regarding a receiver's power to accept, modify, or reject private contracts to protect the public interest in the efficient and orderly rehabilitation of a workers' compensation insurer. *See Ky. Cent. Life Ins. Co. v. Stephens*, 897 S.W.2d 583, 587 (Ky. 1995) (recognizing the rehabilitator's police powers). This Court does not normally disturb a court's judgment on issues so heavily dependent on state law. *See Runyon v. McCrary*, 427 U.S. 160, 181 (1976).[11]

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[11] Additionally, in light of recent decisions from the Kentucky Supreme Court, any remand of this case will cause that court to consider whether Ernst & Young failed to appeal the circuit court's opinion in accord with the Kentucky Rules of Civil Procedure. *See North Fork Collieries, LLC v. Hall*, 322 S.W.3d 98, 101 (Ky. 2010) (recognizing, in a decision after this case, Civil Rule 65.07 as the appropriate method for appeal of decisions denying motions to compel arbitration when the Kentucky Arbitration Act is, as here, inapplicable). Ernst & Young filed their appeal under the Kentucky Arbitration Act, Ky. Rev. Stat.

The arbitration agreement is not enforceable because it is expressly subordinate to the mandates of the Kentucky Insurance Code, and that regulatory scheme, particularly the IRLL, provides the Franklin Circuit Court exclusive jurisdiction over this matter. Because such state-law issues would remain on remand regardless of this Court's disposition, the Court should deny the Petition.

CONCLUSION

Ernst & Young presents no compelling reasons for granting its Petition for Writ of Certiorari. Ernst & Young fails to demonstrate that the Kentucky Supreme Court's Opinion applying the McCarran–Ferguson Act is in conflict with a decision of this Court, a decision of a federal court of appeals, or a decision from any state court of last resort. *See* Sup. Ct. R. 10(b)–(c). Ernst & Young further fails to demonstrate that the Kentucky Supreme Court decided an important federal question that has not been settled by this Court. *See* Sup. Ct. R. 10(c). Ernst & Young does not even carry the significantly less strenuous burden of showing that the Kentucky Supreme Court abused its discretion in its method of applying federal law to enforce Kentucky insurance law, which would, in any event, constitute insufficient grounds to grant its Petition. *See* Sup. Ct. R. 10. Finally, even if this case did present the sort of federal question that would justify granting the Petition, and it does not, it would remain an inappropriate vehicle

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Ann. § 417.220, and Civil Rule 73.02. This state-law issue would remain on remand regardless of this Court's disposition and is another reason why the Court should deny the Petition.

for answering that federal question as a result of threshold issues of state law.

Accordingly, Respondent Sharon P. Clark respectfully requests that the Court deny the Petition.

Respectfully submitted,

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APPENDIX

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Ky. Rev. Stat. Ann.
§ 304.33-150 ..... 55b
Ky. Rev. Stat. Ann.
§ 304.50-110 ..... 56b

APPENDIX A

COMMONWEALTH OF KENTUCKY
FRANKLIN CIRCUIT COURT
DIVISION II

CIVIL ACTION NO. 04-CI-01067

[Filed December 8, 2005]

R. GLENN JENNINGS, IN HIS CAPACITY AS EXECUTIVE DIRECTOR KENTUCKY OFFICE OF INSURANCE	)
PETITIONER	)
V.	)
AIK COMP F/K/A ASSOCIATED INDUSTRIES OF KENTUCKY SELECTIVE SELF-INSURANCE FUND	)
RESPONDENT	)

FINDINGS OF FACT AND CONCLUSIONS OF LAW AND ORDER

This matter came on for hearing without intervention of a jury on October 11, 2005, pursuant to a Notice as approved by the Court given by the

Petitioner on or about September 28, 2005. The hearing was scheduled by the Court pursuant to KRS 304.33-160 on the request of the Rehabilitator to approve a plan of reorganization and a plan of assessment for AIK Comp f/k/a Associated Industries of Kentucky Selective Self-Insurance Fund, pursuant to KRS 304.33-160. The Rehabilitator was represented by Walter L. Sales and Justin D. Clark of Ogden Newell & Welch and by William J. Nold of the Office of Legal Services of the Commonwealth of Kentucky. The Trustees of AIK Comp were represented throughout these proceedings and at the hearing by Charles Greenwell and Charles Middleton of Middleton & Reutlinger. Approximately 500 AIK Comp group members intervened in this action, represented by approximately 60 different law firms. Exhibit 1 to these Findings of Fact and Conclusions of Law is a list of all of the law firms who were given notice of this hearing. Appearing in person at the October 11 hearing were the following lawyers and law firms representing their members: Janet Craig, Stites & Harbison; Greg Mitchell, Frost Brown Todd; David Hale, Reed Weitkamp Schell & Vice; Dandridge Walton, Hazelrigg & Cox; Frank Chuppe, Wyatt, Tarrant & Combs; Bradford Bollman, Schiller Osbourn & Barnes; Schuyler Olt, Pedley, Zielke, Gordinier & Pence; David Faughn, Miller, Griffin & Marks; and David Bratt. Also appearing at the hearing was an individual group member of AIK Comp; Art's Electric Company, and Carol Kolber and Chuck Milliner, representing various AIK Comp group members to observe the proceedings. Also appearing at the hearing was Alan Cobb, representing Kathy Baker, a former officer of AIK Comp. None of those appearing objected to the requested approval of the plan of reorganization or the assessment plan, except for David Faughn with

Miller Griffin & Marks (hereinafter referred to as the "MGM intervenors"). Despite notice of the proceedings none of the other intervenors appeared at the hearing, though all were given notice of the proceedings. No procedural objections to notice or to the conduct of the proceedings were heard or presented.

The MGM intervenors stated in open court that they did not object to the amount of the deficit as determined by the Rehabilitator, nor did they object to the method of allocating that deficit among the group members of AIK Comp, but objected to the following points:

- Jurisdiction of this Court;

- Constitutionality of Sections 50 and 51 of Senate Bill 86;

- Their joint and several liability for the deficit;

- Being subject to an interest penalty of 1% per month if they do not pay the assessment in the manner called for by the reorganization plan and the assessment plan;

- Being subject to pay attorneys' fees of the Rehabilitator for litigating and/or refusing to pay assessments;

- Not being released from joint and several liability and not enjoying the benefits of third party recoveries if they fail to pay in accordance with the assessment plan; and

- Being subject to a "show cause" procedure to collect assessments from them as opposed to requiring the filing of new lawsuits.

Witnesses called on behalf of the Petitioner were Ernest Dry, Special Deputy Rehabilitator; Joseph Pope, Special Deputy Rehabilitator; Shawna Ackerman of Pinnacle Actuaries, Inc.; Lee Groza of Mountjoy and Bressler; and Robert Glenn Jennings, Executive Director of the Office of Insurance and Rehabilitator of AIK Comp.

No intervenor called witnesses.

The hearing began at 10:00 a.m. on October 11, 2005 and concluded that same day at approximately 2:30 p.m. Following the conclusion of all testimony, Janet Craig of Stites & Harbison and Greg Mitchell of Frost Brown Todd spoke in favor of the reorganization plan and the assessment plan presented by the Rehabilitator. The MGM intervenors objected to the assessment and reorganization plans and were directed to file written objections within five (5) days of the close of the hearing and proposed findings of fact and conclusions of law were directed to be filed by counsel for the Rehabilitator within ten (10) days of the close of the hearing.

The Rehabilitator and Counsel for certain group members both filed Amended Proposed Findings of Fact and Conclusions of Law. The Trustees have filed Exceptions to the Petitioner's (Rehabilitator's) Amended Proposed Findings of Fact and Conclusions of Law. All filings have been reviewed and considered by the Court.

FINDINGS OF FACT

The participants:

1. The Petitioner, R. Glenn Jennings, is the duly appointed Executive Director of the Office of Insurance, Commonwealth of Kentucky since April 28, 2005, and the Court appointed Rehabilitator of AIK Comp pursuant to KRS 304.33-150.

2. AIK Comp is an unincorporated association of members who qualify as a workers' compensation self-insured group under Kentucky law and who associate jointly to self-insure their workers' compensation liabilities. KRS 342.350(4); KRS 304.50-010.

3. The trustees of AIK Comp are the trustees duly appointed by AIK Comp's sponsoring organization, AIK, Inc., formerly known as Associated Industries of Kentucky, Inc. ("AIK Inc.").

4. The intervenors are group members of AIK Comp, that is, employers in the Commonwealth of Kentucky who, between January 1, 1999 and February 28, 2005, were credited with earned premium paid to AIK Comp for workers' compensation liability self-insurance coverage. These group members filed applications for coverage with AIK Comp, and in so doing, agreed to be bound by the bylaws of AIK Comp (Rehabilitator's Exhibit 6), the indemnity agreement filed by AIK Comp with the then Kentucky Department of Workers' Claims. (Rehabilitator's Exhibit 8), and by Kentucky law.

JURISDICTION

5. Pursuant to KRS 304.33-040(1) the Petitioner has the authority to commence a delinquency or receivership proceeding against AIK Comp.

6. Pursuant to KRS 304.33-040(1) this Court has exclusive jurisdiction to entertain, hear and determine all matters in any way relating to AIK Comp's receivership, including all issues presented at the hearings before this Court, which are identified herein. The Court may issue any order, process or judgment necessary or appropriate to carry out the provisions of KRS 304, Subtitle 33.

HISTORY OF AIK COMP

7. AIK Comp has been in the business of being a group self-insurer for workers' compensation liabilities for employers in the Commonwealth of Kentucky since 1979. In order to have coverage for workers compensation liabilities with AIK Comp, an employer must also be a member of its sponsoring organization, AIK, Inc. (See Letter of April 24, 1979, ONW 039027-039030; part of Rehabilitator's Exhibit 9.)

8. Beginning in 1997, AIK Comp began discounting its premiums to its members. In 1999, according to an analysis performed by Special Deputy Rehabilitator Joseph Pope on a retrospective basis, AIK Comp went into a deficit position from an operations basis.

9. AIK Comp had its financial statements audited annually by outside certified public accountants. The audit reports for the years 1999 through 2002 reflects AIK Comp as having positive fund balances, as follows:

- For the year ending December 31, 1999, a fund balance of $11,664,477.00 (Rehabilitator's Exhibit 38T);

- For the year ending December 31, 2000, a fund balance of $11,384,565.00 (Rehabilitator's Exhibit 38U);

- For the year ending December 1, 2001, a positive fund balance of $6,532,221.00 (Rehabilitator's Exhibit 38U)[1];

- For the year ending December 1, 2002, a positive fund balance of $46,588.00 (Rehabilitator's Exhibit 38V).

10. In June, 2004, realizing that it was in a deficit position, AIK Comp attempted a remediation with the Office of Workers' Claims and informed its members of such. (Rehabilitator's Exhibit 2.)

11. Ultimately, the trustees of AIK Comp decided that they were unable to remediate and agreed to a rehabilitation under the auspices of the Executive Director of the Office of Insurance pursuant to KRS 304.33.040, -140, and -150. (Rehabilitator's Exhibit 3.)

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[1] The auditors later restated the fund balance for the year ending December 31, 2001 to $4,754,248.00 (Rehabilitator's Exhibit 38V).

PROCEEDINGS TO DATE

12. On August 3, 2004, Governor Fletcher issued Executive Order 2004-835, which transferred regulatory authority over group workers' compensation self-insured groups from the Office of Workers' Claims to the Office of Insurance. Accordingly, the AIK Comp trustees voluntarily entered and agreed to the placement of AIK Comp into rehabilitation (Rehabilitator's Exhibit 44; Petition for Rehabilitation filed August 5, 2004). The Rehabilitator at the time, Martin Koetters, appointed Ernest Dry and Joseph Pope as Special Deputy Rehabilitators pursuant to KRS 304.33-160(1). Both Pope and Dry have significant successful executive experience with insurers.

13. Shortly after this Court ordered rehabilitation, the Special Deputy Rehabilitators sent a notice (Rehabilitator's Exhibit 4) advising the AIK Comp group members of the rehabilitation and of the ways that members could communicate with the Special Deputy Rehabilitators who were now fully in charge of the management and operations of AIK Comp.

14. On October 14, 2004, the Special Deputy Rehabilitators sent a letter to all AIK Comp group members advising them, among other things, of the likelihood and imminent filing of an assessment plan. The assessment plan implemented in November, 2004 (the "Plan of Initial Assessment" or the "PIA") was based upon a deficit existing as of December 31, 2003 of approximately $60,000,000.00 as determined by James E. York, a financial examiner with York Consulting, Inc., who was retained by the Office of

Workers Claims to perform a financial examination. (Rehabilitator's Exhibit 11). Upon completion of the financial examination by Larry Shores with Shores Tagman & Company, certified public accountants, the deficit for 2003 was determined to be $63,415,926.00 (Rehabilitator's Exhibit 14). The AIK Comp group members were notified of PIA, as were the agents for these members.

15. In late November and early December, 2004, several group members intervened and filed a motion to dismiss the rehabilitation petition, arguing principally that group self-insurers, such as the members of AIK Comp, are not subject to regulation under the insurance laws by virtue of KRS 342.350(4), which slates in pertinent part that:

> Employers securing certification as group self-insurers are regulated by the administrative regulations drawn by the commissioner and are not to be in any way subject to the provisions of subsections (1), (2) and (3) of this section...

16. The intervenors who moved to dismiss also argued that because AIK Comp was a self-insurance fund, there was no technical transfer of risk such that AIK Comp could be deemed an insurer within the meaning of KRS 304.33-030(4) or KRS 304.1-040.

17. At a hearing on January 27, 2005, the Rehabilitator advised the Court and all parties of new legislation that was filed and would correct any potential jurisdictional defects. Thereafter, without objection, this Court did not rule on the Motions to Dismiss and directed the parties to mediation.

18. On March 1, 2005, Governor Fletcher signed Senate Bill 86, which amended the insurance and rehabilitation statutes and the workers compensation laws in a variety of ways pertinent to the instant matter. Most significantly, Senate Bill 86 amended KRS 342.350(4) to repeal the exemption for group self-insurers from regulatory oversight by the insurance laws of the State cited above. Second, Senate Bill 86 amended KRS 304, subtitle 33, specifically to include workers' compensation self-insurance groups covered persons subject to subtitle 33. Third, Senate Bill 86 was retroactive to August 1, 2004 and it confirmed Governor Fletcher's executive order transferring jurisdiction from the Office of Workers' Claims to the Office of Insurance.

19. Following the enactment of Senate Bill 86, the Rehabilitator moved for permission to amend his petition in light of Senate Bill 86 and that motion was granted. An Amended Petition was filed by the Rehabilitator and was ordered to be filed by this Court on March 15, 2005.

20. The mediation ordered by the Court at the January 27, 2005 hearing concluded and was at least partially successful by late March, 2005. As a result of that mediation, this Court entered an Order of April 7 requiring the Rehabilitator to file an assessment plan and a reorganization plan by June 15 and setting forth a procedural and discovery schedule leading to a hearing to determine whether this Court would approve the June assessment and reorganization plans. The Rehabilitator sent a notice of that Court Order to all AIK Comp group members in a letter dated April 8, 2005 (Rehabilitator's Exhibit 19B) and

posted the April 7 Order and the April 8 letter on AIK Comp's website.

21. In accordance with the Order of April 7, 2005, the Rehabilitator, on June 15, 2005, filed a new assessment plan based upon the total deficit of AIK Comp as of February 28, 2005. Additionally, the Rehabilitator filed a Reorganization Plan on June 15. The Plan of Initial Assessment filed on November 5, 2004 sought to recover assessments to fill a deficit as of December 31, 2003. The June 15 assessment sought assessments from group members to cover a deficit developed through February 28, 2005, the last day on which AIK Comp continued to provide workers compensation insurance coverage.

22. Additionally, the June assessment plan contained a methodology change from the Plan of Initial Assessment by allocating the deficit based on standard premium as opposed to allocating the deficit based on billed earned premium.

23. After the Rehabilitator filed the assessment plan and reorganization plan in June, 2005, both plans were posted on AIK Comp's website. Thereafter, intervenors representing several hundred group members and the Rehabilitator engaged in extensive discovery. On July 13, 2005, pursuant to the orders of this Court, the Rehabilitator gave notice to all group members of a hearing that was scheduled for September 14, 2005 on the Rehabilitator's request to approve the Assessment Plan and Reorganization Plan of June 15, 2005 and of the right of the group members to object if they wish to do so by intervening on or before July 29, 2005. (Rehabilitator's Exhibit 20.) That notice was sent by first class mail and was also

published in The Louisville Courier-Journal and The Lexington Herald-Leader. (Rehabilitator's Exhibit 21 & 22.)

24. The Court again ordered the parties to mediation immediately prior to the hearing of September 14. After two days of meetings, with the assistance of mediator, Michael Troop, the Rehabilitator and the other parties to the mediation reported on September 14 that they made significant progress and had reached tentative settlement. The settling intervenors were basically those intervenors who had participated in this proceeding and had complied with the pre-trial orders of this Court by filing witness and exhibit lists and responded to discovery. On September 23, 2005, the settling intervenors and the Rehabilitator confirmed that a settlement had been reached on acceptable modified terms of a reorganization plan and assessment plan which would be approved by Mr. Jennings as Executive Director of the Office of Insurance and as Rehabilitator of AIK Comp and would require this Court's approval.

25. This Court assigned October 11 for a hearing on the assessment plan and reorganization plan now being proposed by the Rehabilitator in accordance with the settlement reached between the Rehabilitator and the settling intervenors. On September 29, 2005 the Rehabilitator gave notice to all group members of the modified assessment plan and reorganization plan and of the hearing scheduled for October 11. (Rehabilitator's Exhibit 29). That notice was published in four major newspapers; The Louisville Courier-Journal, The Lexington Herald-Leader, The Paducah

Sun, and The Kentucky Post. (Rehabilitator's Exhibits 30, 31, 32, & 33).

26. On October 11, 2005, the hearing was held on the Rehabilitator's request to approve the assessment plan (the "2005 Assessment Plan") and reorganization plan (the "Modified Reorganization Plan") which are attachments to the Settlement Agreement (Rehabilitator's Exhibit 34A-34K). No AIK Comp member appeared to object to the assessment plan or the reorganization plan, or to the Settlement Agreement reached by the Rehabilitator with the settling intervenors, with the exception of the MGM intervenors.

27. The MGM intervenors did not offer any evidence; but reserved their right to object to their joint and several liability, and they have since joined in a Motion to Dismiss filed by the Stites intervenors and others challenging the constitutionality of Sections 50 and 51 of Senate Bill 86. The Rehabilitator has moved to strike the MGM notice of joinder on grounds that it is moot. The MGM intervenors also object to provisions of the assessment and reorganization plan which would require that they pay interest on unpaid assessments in the amount of 1% per month, that they pay the attorney's fees of the Rehabilitator in any proceeding to collect those assessments if the Rehabilitator is successful, and that they not participate in any fashion in the recovery of funds from third parties who may have caused the AIK Comp deficit. The MGM intervenors also object to the provisions of the 2005 Assessment Plan and Modified Reorganization Plan which allows the Rehabilitator to proceed against and to obtain a judgment against group members who refuse to pay the assessment by

a "show cause" procedure as opposed to the commencement of a new civil action. Finally, the MGM intervenors object to being excluded from an early release of joint and several liability if they do not pay their assessments timely in accordance with the assessment plan.

28. As to the joint and several liability claim, many of the group members have taken the position that they were induced to join or remain a member of AIK Comp by financial statements showing that AIK Comp enjoyed a surplus when in fact it was in a deficit position and also by virtue of the failure of AIK Comp's management to secure adequate aggregate excess insurance to "secure adequately unpredictable losses" in accordance with 803 KAR 25:026, § 7. The group members who object to joint and several liability take the position variously that either they were fraudulently induced to remain or to become a member of AIK Comp, or that AIK Comp engaged in a material breach of the underlying contract with the members. In either event, they argued that they should not be required to remain jointly and severally liable for the obligations of AIK Comp, and should be allowed to rescind the contract.

29. The Rehabilitator moved for Partial Summary Judgment on the joint and several liability issue, arguing that joint and several liability is a statutory and regulatory mandate, and that contractual defenses such as fraudulent inducement or material breach cannot serve as a defense to joint and several liability because many employers/group members would be unable to self-insure their own liabilities which would cause many injured workers to lose the statutory workers' compensation liability

coverage. Additionally, the Rehabilitator has taken the position that once an injured worker becomes a claimant, that injured worker then becomes a creditor of AIK Comp, and as an unincorporated association, all members of that association are liable for the properly incurred debts of the association. Finally, the Rehabilitator argues that the defense of rescission available to parties to a contract if they were fraudulently induced to enter into the contract or in the event there was a material breach in the contract is not available to the group members here under traditional contract law because: (1) the rights of third parties (injured workers) have intervened; and (2) group member's have not timely or effectively made the choice available to them (affirmance of the contract or rescission) or taken any other steps consistent with a realistic intent to disaffirm the contract and seek rescission.

30. In this connection, the Rehabilitator supported his Motion for Partial Summary Judgment with the affidavit of Special Deputy Rehabilitator, Ernest Dry, which confirmed that there were at least a couple hundred group members who were not locatable, and therefore, their injured workers would likely have no coverage in the event joint and several liability were not enforced against the remaining members. Dry also testified that no AIK Comp group member had asked or insisted that AIK Comp stop paying benefits to their own injured workers because that group member intended to cover its employees itself out of a desire to rescind the contract. According to Dry, AIK Comp has continued to provide workers' compensation coverage to all injured workers, and had not missed or failed to pay a single claim of an injured

worker who properly presented a claim for workers' compensation coverage.

31. The Court also notes that the indemnity agreement filed by AIK Comp with the Office of Workers' Claims pursuant to 803 KAR 25:026, § 3(f) (Rehabilitator's Exhibit 7) states that:

> The members of this fund do jointly and severally covenant and agree that they will pay any such award as would otherwise be a claim against the aforesaid surety bond or securities as soon as the same shall become payable under the laws under the state of Kentucky; and the group agrees to pay such assessments as may be ordered by the Commonwealth of Kentucky under Chapter 342 of the Kentucky Revised Statutes.

32. In that same Indemnity Agreement, it is also stated:

> That the members of said fund execute a covenant or agreement whereby in addition to the collateral just above mentioned, the fund and its members will jointly and severally covenant to assume and discharge, by payment, any lawful awards entered by the Board against any member of this group which award shall have been sustained by the Courts or an appeal by either party is taken.
>
> That the members of the fund execute a covenant or agreement whereby the fund and each member thereof would jointly and severally covenant and agree to pay premiums

> and assessments, based upon appropriate classifications and rates, into a designated cash reserve fund out of which lawful and proper claims and awards are to be paid, and further, that the group member would jointly and severally covenant and agree that there will be no disbursements out of this fund by way of dividends or distribution of accumulated reserves to the respected members, except at the direction of the trustees. (Rehabilitator's Exhibit 7).

33. This Indemnity Agreement was filed with the Office of Workers' Claims at the inception of the fund and incorporated by reference into every member's application for coverage that is made with AIK Comp. That AIK Comp membership application agreement states:

> That, by this reference, the terms and provisions of the Indemnity Agreement and/or amendments heretofore filed or which may hereafter be filed with the Kentucky Workers Compensation Board are hereby adopted, approved, ratified and confirmed by us; and further, I (we) agree to assume all the obligations set forth therein, including, but not limited, to our joint and several liabilities for payment of any lawful awards against any member of the fund; and in the event, I (we) fail to pay any premium or lawful assessment within thirty (30) days of the date the same shall be come due, I (we) will pay all costs of the collection thereof, including reasonable attorneys' fees. (Rehabilitator's Exhibit 8.)

34. In that same application, each AIK Comp group member agrees:

> To abide by the rules, regulations, and by-laws of the fund and to conform to the terms of the agreements they may enter into with any authorized service company as long as we remain a member of the fund.

35. The by-laws of AIK Comp (Rehabilitator's Exhibit 6) also confirms these undertakings. Article I, Section 6 of the by-laws stales that:

> Each member of the Fund, by their participation in the Fund, shall adopt and ratify these by-laws and other rules, regulations, and requirements provided by the Fund or imposed on the Fund by state or federal law or authorized by action of the trustees of the Fund.

36. Section 8 of the by-laws identifies the objectives of the fund:

> To formulate, develop and administer a program of self-insurance for the membership of the fund; to obtain lower costs of workers compensation and other insurance coverages; provide excess insurance coverage; and develop a comprehensive safety program; to perform any and all other functions necessary to have a cost effective workers compensation program. All the above mentioned activities shall be performed as agent and representative of the various participants of the fund.

37. According to the by-laws in Article 3, Section 1, the Board of Trustees of AIK Comp are granted the power to, "make additional assessments on a pro-rata basis to protect the financial integrity of the fund and to pay all claims against fund members."

38. On September 6, 2005 this Court sustained the Rehabilitator's motion for partial summary judgment finding as a matter of law that the AIK Comp group members were jointly and severally liable for the AIK Comp deficit.

THE SETTLEMENT AGREEMENT

39. The settling intervenors and the Rehabilitator entered into a Settlement Agreement on October 3, 2005. Attached to that Settlement Agreement (Rehabilitator's Exhibit 34) is the Modified Reorganization Plan and the 2005 Assessment Plan which the Rehabilitator proposes to implement and which the Rehabilitator seeks this Court's approval.

40. The Modified Reorganization Plan provides that the Rehabilitator shall operate and manage AIK Comp in a self run-off mode for the foreseeable future. While the goal of the reorganization is ultimately a capping of liability for the group members of AIK Comp, that can only occur in the near term if there is a transfer of assets and a reliable transferee willing to cap each member's liability. It was explained that a transfer of that nature, commonly referred to as a loss portfolio transfer (LPT), may not currently be economically feasible for two primary reasons: (1) assessments are needed to cover the liabilities of the fund which could last for 20-25 years, and (2) another few years of loss development will be

necessary to convince any potential transferee that a sufficiently precise and accurate prediction of AIK Comp's ultimate claims liability exists to justify a reasonably priced transfer.

41. To achieve the goal of capping member liability through a transfer and securing the payment of claims of injured workers for workers' compensation benefits, the Rehabilitator has proposed to collect an assessment as set forth in the 2005 Assessment Plan, and to manage AIK Comp in rehabilitation as efficiently and as economically as possible. As further set forth below, the 2005 Assessment Plan seeks to collect assessments from AIK Comp group members on a pro-rata basis in the amount of approximately $90,775,774.00. Eighty percent (80%) of that is anticipated to be collected through the assessment within sixty (60) days of the anticipated order of this Court.

42. The Modified Reorganization Plan calls for the collection of these assessments, and identifies a goal as releasing members from joint and several liability who promptly pay assessments as they come due with a combination of cash and callable notes. Though prompt payment is necessary, according to the Modified Reorganization Plan, provisions are made for hardship payment plans on a case-by-case basis. Additionally, members will be able to contest the calculation of individual assessments and other individualized objections they may have through an expedited proceeding conducted by this Court or by a special master/commissioner operating pursuant to this Court's orders.

43. On an ongoing basis, it is also anticipated that the group advisory committee which was established pursuant to this Court's order of April 7, 2005 will continue, and could expand or change as needed to facilitate the exchange of information between the group members and the Rehabilitator and as a forum for resolving concerns amicably, rather than through confrontation/litigation.

44. The 2005 Assessment Plan assesses the members for a deficit which is supported both by the actuarial loss reserve estimate prepared by Pinnacle Actuaries and an audit report for the year ending February 28, 2005 reflecting a deficit of $90,775,774.00. The Rehabilitator determined in hindsight that AIK Comp slid into a deficit position in 1999 from which it has not emerged. The deficit has grown each year. The Rehabilitator and Special Deputy Rehabilitators determined the amount of the deficit which can be fairly allocated for each year between 1999 and February 28, 2005. Members are assessed for their pro-rata portion of the deficit for each year between 1999 and 2005 that AIK Comp received earned premium from that member. If a member was credited with earned premium in 1999, but not thereafter, then that member only pays a pro-rata portion of the deficit allocable to 1999.

45. The Rehabilitator has also determined to pro rate each member's assessment based upon the difference between what the assessment would be if it were calculated according to standard premium and what it would be if calculated according to the billed earned premium. The PIA used the methodology of billed earned premium of each member in any particular year compared to the billed earned

premiums of all members of that year. Under the June 15, 2005 assessment plan, the Rehabilitator had used a calculation which added back into the formula the AIK Comp special discounts received by many of its members. That had the effect of causing members who received the greatest discounts to have a larger assessment than if their billed earned premium alone was used as a reference.

46. The compromise in the settlement agreement of using one-half of the AIK Comp special discount is fair and reasonable because it represents a balancing of all of the interests of all of the members. The Court finds that this compromise is fair because it takes into account the interests of the injured workers in making sure that their claims for workers' compensation benefits are satisfied, and it balances all of the interests of all AIK Comp group members.

47. Approximately one percent (1%) of AIK Comp group members had what is known as retrospectively rated policies which means that the premiums were calculated in the same way as fixed premium policies (including the AIK Comp special discounts), but that the actual premium paid by that group member would change according to that group member's particular claims experience. There was both a floor and a ceiling below and above which a member's premium could not fluctuate. Group members with retrospective premium policies will also be required to pay an assessment defined as the ratio of their audited written provisional premium plus one-half of the AIK Comp discount in relation to all member's audited earned premium plus one-half of all AIK Comp discounts given in that year, or the same ratio but decreased by that member's particular claims

experience, whichever is less. In that fashion, according to the Special Deputy Rehabilitators, the retrospective policy holder retains the benefit of their bargain while still remaining liable for a fair proportionate share of the deficit. The Court finds that this compromise is fair and takes into account the interests of the injured workers in ensuring the payments of their workers' compensation benefits are made, and a balancing of all of the interests of all AIK Comp members.

48. Pursuant to the 2005 Assessment Plan group members must pay eighty percent (80%) of their pro-rata share of the assessment in cash and execute contingent callable promissory notes for twenty percent (20%) of their pro-rata share of the assessment within sixty (60) days of mailing of the assessment package by the Rehabilitator unless they qualify for a hardship payment plan. In the event a member does not pay the assessment as required or does not pay any other indebtedness owed to AIK Comp, the Rehabilitator may move the Court to issue an Order directing the defaulting member to show cause why the Rehabilitator should not have judgment against that member for the amount assessed or otherwise owed. A member failing to appear and object upon a return date of an Order to show cause shall have a judgment entered against it together with costs and reasonable attorney's fees.

49. The evidence shows that the membership application signed by each AIK Comp group member provides that AIK Comp may recover its attorneys' fees in the event that it must commence legal action to compel the payment of a lawful premium or assessment.

50. Members who appear and object to the assessment will be entitled to a judicial determination (either by the Court or reference to a referee/special master commissioner) of the merits of their objection as to claims of an individualized nature. That recommendation will become final fifteen (15) days after mailing to the non paying member unless exceptions are filed within that period with the Court. Ultimately, the Court may enter appropriate orders and judgments in conformity with the recommendations of the referee or such other orders as the Court deems appropriate, including the awarding of costs and attorney's fees against the non-paying member. The Court finds that this compromise is fair and takes into account the interests of the injured workers in making sure that their claims for workers' compensation benefits are satisfied, and a balancing of all of the interests of all AIK Comp members. The Court further finds that the collection procedure set forth in the assessment plan affords members both procedural and substantive due process. Such procedures for the entry of a judgment against a policy holder are clearly recognized in KRS Chapter 304, Subtitle 33. The Court further finds that it is in the interests of insureds, creditors and the public in general that the Rehabilitator collect assessments and other indebtedness owed to AIK Comp by group members in a timely manner while protecting the due process rights of assessed members.

51. Members who do not pay their assessments in accordance with the assessment plan will not receive a release or compromise of their liability, are subject to costs, including the reasonable attorneys' fees and interest of one percent (1%) per month beginning on the 91st day following the mailing of the

invoice by the Rehabilitator. The evidence shows that each certificate of coverage sent by AIK Comp to each member contained a statement that an interest charge of 11/2% per month would be added to all overdue and unpaid premiums and assessments.

52. Upon collection of eighty percent (80%) of the total assessment by the Rehabilitator, or under other circumstances as described in the assessment plan, the Rehabilitator may release members who timely pay the assessment from joint and several liability to be replaced with pro-rata several liability. Each member's individual liability will be limited by their proportionate share of the deficit remaining to be collected; but there is no cap on the deficit itself subject to further assessments approved by the Court. The Rehabilitator may apply to the Court for permission to collect the callable notes under certain circumstances and may also seek additional assessments from all members if additional assessments are needed for reasons as specified in the assessment plan. For those members whose joint and several liability have been released, they will still be required to pay an assessment based upon their pro-rata share of whatever additional deficit is determined to exist by the Rehabilitator subject to the approval of this Court. The same will be true of members who do not pay timely but they will not receive a release from joint and several liability. For those members who do not pay in accordance with the assessment plan, their joint and several liability will not be released until and unless all liability of all group members is either transferred or released through a LPT or some other liability transferring mechanism.

53. Finally, the Court takes notice of the pendency of lawsuits commenced by the Rehabilitator, and other AIK Comp group members against various third parties whom may be liable to AIK Comp and/or its members for the deficits of AIK Comp. The parties have pledged in the Settlement Agreement and Modified Reorganization Plan to meet within thirty (30) days of October 11 to try to resolve some of the differences between the Rehabilitator and the AIK Comp group members who have filed lawsuits against some of the same parties. The 2005 Assessment Plan also provides that group members who fail to pay their assessment in accordance with the Assessment Plan will not gain the benefits of a recovery from the third parties if one is had either directly or by way of a reduction of the amount of the assessment owed.

54. The Court finds the method of allocating the deficit among the group members with fixed premium policies and those with retrospective premium policies is fair and reasonable and strikes a fair balance among the members while ensuring the financial integrity of AIK Comp in its ability to satisfy the claims of injured workers for workers' compensation benefits. The Court also finds that the other provisions of the Settlement Agreement, 2005 Assessment Plan and Modified Reorganization Plan as articulated above are also fair and reasonable, including without limitation: the potential for interest charges of one percent (1%) per month charged to non-paying AIK Comp group members, the potential to incur attorney's fees by AIK Comp members who force AIK Comp to expend legal fees to enforce their obligation to pay the assessment, collection procedures which include the show cause hearing for members who do not pay, the objection procedure allowing members to object to their

individual calculation of their assessment and to other individualized inquiries such as the short-rate premium dispute, the hardship provisions which allow a limited delay of the payment for certain qualifying members, and the provision dealing with penalties for group members who fail to pay.

55. The 2005 Assessment Plan calculates the deficit at $90,775,774.00 which is less than the amount the Rehabilitator set as the deficit in the June assessment plan. In the 2005 Assessment Plan the Rehabilitator could count on sufficient infusion of tangible assets (cash and interest bearing notes) that the Rehabilitator could discount reserves by four-and-one-half percent (4-1/2%), resulting in the lower deficit. The four-and-one-half percent (4-1/2%) discount rate is supported by the actuaries and is fair and reasonable.

56. If the Rehabilitator cannot collect the assessments contemplated by the 2005 Assessment Plan in a timely fashion the Rehabilitation will not have the investment income which enabled it to discount reserves. This will cause the deficit to increase. Hence, the Rehabilitator seeks approval of plans which create incentives for group members to pay assessments and disincentives for those who refuse to pay. The Court finds the balance of incentives and disincentives fair and reasonable because it provides cash for payment of claims, reduces the deficit, and enhances the likelihood of an LPT to cap the liability of all members.

CONCLUSIONS OF LAW

I.

1. This Court has exclusive jurisdiction over this delinquency proceeding to entertain, hear, or determine all matters in any way relating to this delinquency proceeding and the Court may issue any order, process, or judgment necessary or appropriate to carry out the provisions of KRS Chapter 304, Subtitle 33. KRS 304.33-040. KRS Chapter 304, Subtitle 33 must be literally construed to effect its purpose to protect the interests of insureds, creditors and the public generally and proceeding under its provisions are an integral aspect of the business of insurance and are of vital public interest and concern. KRS 304.33-010.

2. The proceedings authorized under KRS Chapter 304, Subtitle 33 may be applied to AIK Comp as a workers' compensation self-insured group. KRS 304.33-020(10) to (11).

II.

3. AIK Comp's financial condition is to be measured in accordance with generally accepted accounting principles (GAAP). The Executive Director of the Office of Insurance, the Rehabilitator, his Special Deputy Rehabilitators, the actuaries (Taylor Walker and Pinnacle) and accountants; (Shores Tagman and Mountjoy and Bressler) have complied with those accounting procedures in their analysis of AIK Comp's financial condition.

III.

4. The Executive Director determined and the Court concludes that AIK Comp was in such condition that the further transaction of business would be hazardous to its policyholders, creditors, and the public. Further, the Court finds that two-thirds of the Board of Trustees of AIK Comp consented to the Rehabilitation. Accordingly the grounds for rehabilitation exist. KRS 304.33-140(1)(f) and (m).

5. All AIK Comp group members, policyholders, and other interested persons received adequate notice of the 2005 Assessment Plan, the Modified Reorganization Plan, and Settlement Agreement, and of the hearing on the 2005 Assessment Plan and Modified Reorganization Plan commencing on October 11, 2005, and were awarded a full, fair and complete opportunity to be heard at the hearing with respect to the Executive Director's plans.

IV.

6. Constitutional challenges to Senate Bill 86 based upon the alleged invalidity of Sections 50 and 51 of that statute relating to the confirmation of the Executive Order under which AIK Comp was originally placed into rehabilitation and the retroactivity of Senate Bill 86 are moot. Senate Bill 86 was signed into law by Governor Fletcher on March 1, 2005 as emergency legislation, effective immediately. Section 50 of Senate Bill 86 ratified the Governor's executive order which transferred enforcement authority over workers compensation group self-insured groups from the Office of Worker' Claims to the Office of Insurance. Section 51 of Senate Bill 86

made the legislation specifically retroactive to August 4, 2004 when the Governor issued his executive order and AIK Comp was placed in rehabilitation.

7. The Rehabilitator amended the petition for rehabilitation effective March 15, 2005. The Amended Verified Petition replaced the previous Verified Petition. Under *Schwindel v. Meade County*, 113 S.W. 3d 159 (Ky. 2003), Kentucky Courts interpret CR 15 and the Federal Rule of Civil Procedure 15 identically. As such and pursuant to analogous federal case law, the filing of the Amended Verified Petition was the equivalent of filing a new action. *Morelan vs. University Guaranty Life Insurance Company*, 298 F. 3d 609, 617 (7th Cir. 2002); *Wellness Community-National v. Wellness House*, 70 F. 3d 46, 49 (7th Cir. 1995). This Court has jurisdiction to maintain this action under SB 86.

8. Furthermore, the Court finds SB 86 to be constitutional, retroactive remedial legislation due to the express language contained therein. *Kentucky Insurance Guaranty Association v. Jeffers*, 13 S.W. 3d 606 (Ky. 2000). SB 86 did not constitute improper special legislation or interfere with vested rights. *Kentucky Industrial Utility Customers v. Kentucky Utilities Co.*, 983 S.W. 2d 493 (Ky. 1998); *Hayes v. State Property and Buildings Commission*, 731 S.W. 2d 797 (Ky. 1987); *City of Paris v. Kentucky Utilities Co.*, 133 S.W. 2d 559 (Ky. 1939).

V.

9. AIK Comp is an unincorporated association, formed for the purpose of incurring and covering workers' compensation liabilities for its members in

accordance with its by-laws and applicable statutes and regulations. Members of AIK Comp are jointly and severally liable for all of the workers' compensation liabilities incurred by AIK Comp. *Jim Host and Associates, Inc. v. Sharp,* 639 S.W. 2d 784 (Ky. App. 1982); and *ING et al. v. Liberty National Bank,* 216 Ky. 467, 287 S.W. 2d 960 (Ky. App. 1926).

10. Moreover, Kentucky requires employers who wish to self insure their worker's compensation liabilities through a group self insurance fund to be jointly and severally liable for those obligations. *See* 803 KAR 25:026, Section 3 interpreting KRS 342.350(4). Contract defenses such as fraud in the inducement or material breach do not vitiate the statutory and regulatory responsibility of joint and several liability which the AIK Comp members have for the worker's compensation liabilities of AIK Comp. *Southwest Adminsitrators, Inc. v. Rozay's Transfer,* 791 F. 2d 769 (9th Cir. 1986). In any event, no AIK Comp member can rescind the contract because none have made any effort to place AIK Comp back into the status quo existing prior to the time when the member in fact joined. *Ruffner v. Ridgely,* 81 Ky. 165, 1883 WL 7819 (Ky. App. 1883); *In re Sallee,* 286 F.3d 878, 889-890 (6th Cir. 2002); Samuel Williston, 12 *Williston on Contracts,* Section 1460 (Walter H.E. Jeger, Editor, 3rd Edition, 1970), (contract may only be rescinded upon a tender of any consideration received is a general principle of law).

VI.

11. The assessment methodology represents a balance of conflicting interests and is a fair and reasonable method of curing the deficit and allocating

it among the group members of AIK Comp. The 2005 Assessment Plan does not violate the terms of the AIK Comp by-laws, indemnity agreement and membership application, and is consistent with applicable statutes and regulations. The Executive Director has not abused his discretion in adopting the assessment plan and the reorganization plan that were part of the Settlement Agreement reached with the settling intervenors.

12. The MGM intervenors' objection to being subject to attorney's fees in the event the Rehabilitator must commence legal action to collect assessments is not well founded. KRS 304.33-060 allows the Rehabilitator to seek attorney's fees incurred in pursuing litigation in any proceeding under KRS 304, Subtitle 33. Moreover, all AIK Comp members agreed when they became members of AIK Comp to pay reasonable attorneys' fees incurred by AIK Comp if AIK Comp were required to enforce its right to collect past due premiums and assessments. Accordingly, the Rehabilitator has the right to seek, and therefore to agree to seek attorney's fees and expenses incurred in pursuing litigation in any proceeding under KRS 304, Subtitle 33. The Court retains the right in appropriate cases to grant or deny an application for attorney's fees and expenses, and notes that currently no such specific request is pending.

13. It is well within the discretion of the Rehabilitator to assess interest against members who do not pay the assessment. Failure to collect interest will in fact cause the deficit to increase. AIK Comp group members agreed to pay interest at the rate of one and one-half percent (1-1/2%) per month on any unpaid premiums or assessments in their certification

of coverage the member receives from AIK Comp. Accordingly, it is fair and reasonable for the Rehabilitator to collect one percent (1%) per month.

14. Determining whether there has been a due process violation, Kentucky courts apply a test found in *Matthews v. Eldridge,* 424 U.S. 319, 333-35 (1976), which requires consideration of the private interest that will be affected by the official action; the risk of an erroneous deprivation of such interest with the procedures used; the probable value of additional or substitute procedural safeguards; and the government's interest any additional procedural requirement would entail. See *Division of Driver Licensing v. Bergman,* 740 S.W.2d 948, 951 (Ky. 1987). The Kentucky Court of Appeals in *Masood v. Kentucky Board of Medical Licensure,* 2005 WL 195363 (Ky. App. 2005) reviewed whether Dr. Masood's constitutional right to due process was violated by the trial court's review of KRS 311.571(8). Because the licensing statute involved there provided for a formal hearing pursuant to a show cause order this satisfied the *Eldridge* element of an additional safeguard of due process. See also *McGarry v. State,* 496 So. 2d 138 (Fla. 1986) where the court held that a show cause hearing was an adequate procedural safeguard for a member of an unincorporated association who was ordered to make restitution. Accordingly, the court concludes that the show cause procedure in the 2005 Assessment Plan contains adequate procedural and substantive safeguards for the protection of the constitutional due process rights which the MGM intervenors claim are missing from the assessment plan.

15. Moreover, in *Scott v. Lloyds of America of San Antonio,* 11 F.Supp. 787, 790 (W.D.Tex. 1935),

members of an unincorporated insurance association licensed under state law is subject to the control of insurance authorities. The association's attorney was designated by law to accept service of process and could bind association members in issuance of insurance contracts. The association was therefore suable in its collective name and members were bound by the judgment rendered against them in that name. Kentucky case law is consistent with that principle. *Jim Host & Associates, Inc. v. Sharp*, 639 S.W.2d 784, 785 (Ky. App. 1982). See also *Maher v. Zapata Corporation*, 714 F.2d 436 (5th Cir. 1983), where the rights of shareholders in the derivative action could be finally determined in a fairness hearing on a settlement with a show cause order. Hence, the show cause provisions of the assessment plans for members who fail to pay are reasonable and within the sound discretion of the Executive Director to implement.

16. See also *Ballesteros v. New Jersey Property Liability Insurance Guaranty Association*, 530 F. Supp. 1367 (D. NJ. 1982) where the Court held that due process was not offended when a policyholder's rights under their insurance policy were terminated without service of process where the policyholder was notified of the cancellation of his policy by the receiver by first class mail.

17. The Executive Director also proposes to release members who pay their assessment in a timely fashion pursuant to the 2005 Assessment Plan from joint and several liability and replace that joint and several liability with a *pro rata* several liability. The Executive Director also proposes that members who do not pay their assessments in a timely fashion according to the assessment plan will not have that

joint and several liability released until and unless there is a transfer of the liabilities and assets from AIK Comp to a third-party who can then release that liability for all. The Executive Director has "broad discretion in his efforts to rehabilitate the company," and KRS 304.33-160(2) "provides that as rehabilitated the commissioner may take such action as deemed necessary or appropriate to reform or revitalize the insurer. Full powers are granted to deal with the property and business of the insurer." *Minor v. Stephens,* 898 S.W.2d 71, 80 (Ky. 1995).

18. In this case, it is vital to the success of AIK Comp's rehabilitation that it receive a prompt and timely infusion of cash. This is necessary to provide financial integrity for the payment of workers' compensation claims for the benefit of injured workers and will also benefit the entire population of AIK Comp group members who will be better served the sooner the Rehabilitator can arrange for a LPT or some other form of risk capping transfer. Moreover, the public interest will be served in ensuring that workers' compensation claimants do not become wards of the state, and in maintaining a strong and reliable market for workers' compensation group self-insurance. Accordingly, it is within the discretion of the Executive Director to provide incentives for the timely payment of assessments and to withhold certain benefits from members who compromise the ability of the rehabilitator to achieve the goals outlined above.

19. Traditional contract notions and other contract rights are not inviolate in the context of a rehabilitation of an insurer. As stated in *Minor v. Stephens, supra,*

> "Neither the insurance company nor policyholders have inviolate rights that characterize ordinary private contracts. The policyholders' contracts as well as others with interest in the company, are subject to a reasonable exercise of state police power."

Accordingly, the Executive Director as Rehabilitator is operating within his authority in adopting a plan which conditions the release of joint and several liability to be replaced with *pro rata* several liability upon timely compliance with the assessment plan.

20. For the same reasons, the Executive Director as Rehabilitator is operating well within his discretion in recommending that any third-party recoveries from those who might be ultimately determined to have caused the deficit at AIK Comp benefit only those members who timely pay their assessments in accordance with the assessment plan.

21. The Court has made no final and binding determination of the cause of the AIK Comp deficit, and these findings of fact and conclusions of law should not be used or construed to determine the cause of the AIK Comp deficit or who was responsible for causing that deficit.

22. The Executive Director, as rehabilitator, has the power and duties set forth in KRS 304.33-160.

23. The Modified Reorganization Plan and the 2005 Assessment Plan which was the subject of the hearing on October 11, 2005 is approved and the

Rehabilitator shall commence to carry out the clarification and implement both.

24. The Modified Reorganization Plan and the 2005 Assessment Plan are subject to modification and clarification through further orders of the Court.

Wherefore, the Rehabilitator is ordered to proceed with implementation of the Modification Reorganization Plan and the 2005 Assessment Plan consistent with the Findings and Conclusions herein.

SO ORDERED, this 8 day of December, 2005.

/s/ William L. Graham
William L. Graham
Franklin Circuit Court
Division II

APPENDIX B

COMMONWEALTH OF KENTUCKY
FRANKLIN CIRCUIT COURT
DIVISION II

CIVIL ACTION NO. 05-CI-455

[Filed March 29, 2005]

MARTIN J. KOETTERS, EXECUTIVE DIRECTOR KENTUCKY OFFICE OF INSURANCE AS REHABILITATOR OF AIK COMP, FOR AND ON BEHALF OF AIK COMP

PLAINTIFF

V.

ERNST & YOUNG LLP

Serve: Any partner pursuant to CR 4.04(4), at
ERNST & YOUNG LLP
400 W. Market Street
Suite 2100
Louisville, KY 40202

DAVID S. MEYER
1900 Scripps Center
312 Walnut Street
Cincinnati, OH 45202

Serve: Secretary of State
152 State Capitol
700 Capitol Avenue
Frankfort, KY 40601

STEPHEN P. LATTANZIO
3555 Veteran's Memorial Highway
Ronkonkoma, NY 11779

Serve: Secretary of State
152 State Capitol
700 Capitol Avenue
Frankfort, KY 40601

ACTUARIAL & TECHNICAL
SOLUTIONS, INC.
3555 Veteran's Memorial Highway
Ronkonkoma, NY 11779

Serve: Secretary of State
152 State Capitol
700 Capitol Avenue
Frankfort, KY 40601

And

JOHN and JANE DOES, all unknown
actuaries and accountants against whom
AIK Comp may have a cause of action and
who may be responsible for damages
alleged herein

DEFENDANTS

*** *** ***

VERIFIED COMPLAINT

Plaintiff, Martin J. Koetters, Executive Director Kentucky Office of Insurance as Rehabilitator of AIK Comp, for and on behalf of AIK Comp ("Plaintiff"), in person and by counsel, for his Verified Complaint against Defendants, Ernst & Young LLP, Stephen P. Lattanzio, Actuarial & Technical Solutions, Inc., and John and Jane Doe defendants, states as follows:

I. JURISDICTION AND VENUE

1. This court has jurisdiction because the amount in controversy exceeds the minimum threshold for the jurisdiction to be invoked, because Defendants were at all times engaged in business in the Commonwealth of Kentucky, because the claims set forth herein arise out of Defendants' tortious and other conduct within the Commonwealth, and because the Rehabilitator brings this action pursuant to authority granted him under KRS Chapter 304, Subtitle 33.

2. Venue of this action is properly in the Franklin Circuit Court pursuant to KRS Chapter 304, Subtitle 33.

II. THE PARTIES

3. Plaintiff is the Executive Director of the Kentucky Office of Insurance. By orders of the Franklin Circuit Court, Division II, in Case No. 04-CI-01067, Plaintiff was appointed and continues to serve as Rehabilitator of AIK Comp with the authority to bring this action under the provisions of KRS Chapter 304, Subtitle 33.

4. AIK Comp is an unincorporated association and a group self-insurance fund as authorized by KRS Chapter 342. AIK Comp consists of employers throughout the Commonwealth of Kentucky who have agreed to jointly and severally pool their workers' compensation liabilities.

5. Defendant Ernst & Young LLP ("E&Y"), is a general partnership registered as a limited liability partnership in the state of Delaware, with its principal office located at 5 Times Square, New York, New York 10036-6530. E&Y is qualified to and does transact business in the Commonwealth of Kentucky. Certain partners of E&Y are residents in and citizens of the Commonwealth of Kentucky. E&Y served as the auditors for AIK Comp from 1998 through 2003, and issued opinions on financial statements, including, but not limited to, an estimate of the loss reserves of AIK Comp for each of those years, with the exception of 2003. Additionally, E&Y prepared AIK Comp's tax returns and other reports as required by Generally Accepted Auditing Standards ("GAAS"), and provided other consulting services as AIK Comp requested.

6. Defendant David S. Meyer ("Meyer") is a partner of E&Y. Meyer provided professional auditing services to AIK Comp from 1998 through 2003. Meyer has engaged in business within the Commonwealth of Kentucky and holds himself out individually as qualified to provide auditing and related services.

7. Defendant Actuarial & Technical Solutions, Inc. ("A&T") is an actuarial firm incorporated under the laws of the State of New York with its principal offices located in the State of New York, and has appointed the Kentucky Secretary of State as its agent

for service of process within the Commonwealth of Kentucky. AIK Comp retained A&T to provide professional actuarial services. A&T provided professional actuarial services to AIK Comp through and including the calendar year 2003. Those professional services included, but were not limited to, the issuance of actuarial opinions, reserve studies, rate studies and other legally required services.

8. Defendant Stephen P. Lattanzio ("Lattanzio") is and at all relevant times was the chairman and Chief Executive Officer of A&T. Lattanzio has engaged in business within the Commonwealth of Kentucky and holds himself out individually, and holds out A&T, as qualified to provide actuarial and related services. Lattanzio, together with A&T, provided professional actuarial services to AIK Comp through the calendar year 2003.

9. The John and Jane Doe defendants (the "Doe defendants") represent all unknown actuaries and accountants against whom AIK Comp may have a cause of action. The Doe defendants also represent those partners at E&Y who are at this time unknown and against whom AIK Comp may have a cause of action.

III. ALLEGATIONS

10. The Franklin Circuit Court, on petition by Martin J. Koetters, Executive Director Kentucky Office of Insurance, placed AIK Comp in rehabilitation by an order entered August 5, 2004.

11. The Franklin Circuit Court ordered Plaintiff, as Rehabilitator of AIK Comp, "to immediately take

possession and control of all the assets, property, books, accounts, documents, and other records of AIK Comp, wherever located, and regardless of whose custody or control they may be found..." Accordingly, Plaintiff took possession of all known assets, including causes of action that AIK Comp could have maintained in its own name.

12. Pursuant to KRS Chapter 304, Subtitle 33, Plaintff has the authority to bring civil actions on behalf of AIK Comp against "any officer, manager, agent, employee, or other person" whom the rehabilitator has reason to believe engaged in "tortious conduct or breach of any contractual or fiduciary obligation detrimental to the insurer [AIK Comp]."

13. Since August 5, 2004, financial statements have been prepared and audited for the year ending December 31, 2003 which reveal a balance sheet deficit of over $60,000,000, and certain members of AIK Comp have been assessed accordingly.

14. Financial statements for the year ending December 31, 2004 are being prepared which, upon information and belief, will reveal that the deficit will substantially increase, thereby necessitating additional assessments upon members.

15. Pursuant to KRS 342.340, each employer in the Commonwealth of Kentucky is required either to insure its workers' compensation liability or provide satisfactory proof of its financial ability to assume such liability.

16. The Commonwealth of Kentucky has permitted employers to use as an alternative to

purchasing insurance in the traditional marketplace the ability to participate in a group self-insurance fund authorized under KRS 342.350(4).

17. Group self-insurance funds such as AIK Comp must file statements of financial condition, audited by certified public accountants, on an annual basis. The financial statement required to be filed by self-insurance groups must include "an actuarial opinion by a member or fellow of the Casualty Actuarial Society and a supporting reserve study regarding reserves for claims and expenses associated therewith." KRS 342.347(2).

18. From 1998 through 2002, E&Y and Meyer were responsible for the audit of the statement of financial condition of AIK Comp that was required to be filed pursuant to KRS 342.347. E&Y served as the independent auditor for AIK Comp and was responsible for, and did in fact audit and issue opinions on, all financial statements that AIK Comp was required to file with regulatory agencies, including taxing authorities, which AIK Comp used and relied upon in marketing its insurance policies to its members and potential members.

19. Defendants A&T and Lattanzio, from 1997 through 2002, were responsible for, and did in fact prepare, actuarial opinions and the supporting reserve studies regarding reserves for claims and expenses incurred by AIK Comp that were relied upon in the preparation of the financial statements, including those described above, and which were required to be filed pursuant to KRS 342.347. AIK Comp relied upon the actuarial opinions and reserve studies prepared by the Defendants A&T and Lattanzio in the preparation

of other financial statements that AIK Comp was required to file with regulatory agencies and authorities. AIK Comp further relied upon these opinions and reserve studies in soliciting and marketing to its members.

20. Defendants A&T and Lattanzio were responsible during this time period for preparing premium rate studies and making recommendations to AIK Comp regarding premium rate adequacy for policies issued by AIK Comp.

21. AIK Comp relied upon all the foregoing opinions and studies prepared by Defendants to establish the premiums for the insurance policies sold and marketed to AIK Comp's members.

22. From 1997 through 2002, Lattanzio and A&T, inter alia, consistently and negligently underestimated the anticipated losses due to claims incurred or to be incurred by AIK Comp resulting in AIK Comp establishing inadequate reserves to pay for those claims.

23. The financial statements audited and opined upon by E&Y and Meyer from 1998 through 2002 were inaccurate and materially misleading because, inter alia, they significantly and materially understated known claims and claims incurred, but not reported, and thus significantly and materially misstated AIK Comp's financial position as having a positive surplus. In fact, AIK Comp had a substantial deficit.

24. In auditing the financial statements from 1998 through 2002, and in providing unqualified audit opinions for those statements which reflected a surplus

for AIK Comp, E&Y and Meyer overlooked and/or ignored historical data, loss trends, and current events, and E&Y and Meyer accepted actuarial assumptions and conclusions that they knew, or should have known, were erroneous.

25. AIK Comp, in reliance upon E&Y, Meyer, Lattanzio, and A&T, set premiums that were inadequate. The premiums were based upon A&T's and Lattanzio's failure to properly calculate real and potential claims. The inadequate premiums charged to members were also based upon E&Y's and Meyer's failure to exercise proper care in the auditing of AIK Comp's financial statements. These failures by E&Y, Meyer, A&T, and Lattanzio caused AIK Comp to report to its members and to the Office of Workers' Claims that it was more financially sound than it really was. Defendants' negligence and misrepresentations regarding the financial soundness of AIK Comp misled regulators, the public, and AIK Comp's members, and delayed effective remedial measures from being taken that could have avoided rehabilitation.

IV. CAUSES OF ACTION

COUNT I – NEGLIGENCE AGAINST E&Y

26. Plaintiff states, reiterates and incorporates herein by reference each of the preceding paragraphs of this Complaint.

27. E&Y provided professional services to AIK Comp in the course of their business to provide accurate and reliable auditing advice and services to AIK Comp.

28. E&Y received compensation and/or remuneration for those services provided to AIK Comp.

29. E&Y violated applicable auditing standards and was otherwise negligent in auditing AIK Comp's financial statements by overlooking, ignoring, or failing to consider historical data, loss trends, and current events and by further accepting actuarial assumptions and conclusions that it knew or should have known were erroneous.

30. E&Y owed a duty of care and prudence to AIK Comp in performing its audits in accordance with GAAS and accepted industry standards to make sure that the statements of financial condition that it certified for AIK Comp were in accordance with Generally Accepted Accounting Principles ("GAAP") and accepted industry standards. E&Y failed to exercise the care and prudence that it owed to AIK Comp, and its failure to exercise the care and prudence that it owed AIK Comp was a substantial factor in causing AIK Comp to suffer losses and other damages in an amount to be proven at trial.

31. E&Y's negligence in auditing AIK Comp's financial statements misled the Kentucky Office of Workers' Claims with respect to the financial condition of AIK Comp. As a result, remedial or other regulatory actions which could have been taken to salvage and save AIK Comp, thereby reducing the costs of assessment and rehabilitation incurred once AIK Comp was placed into rehabilitation, were not taken.

32. Upon information and belief, E&Y regularly audits the financial statements of insurers regulated by various regulatory agencies in the Commonwealth

of Kentucky and other states. Accordingly, E&Y knew or should have known that the information contained in the audited financial statements was misleading, deceptive, and/or inaccurate.

33. As a result of E&Y's negligence as described above in misleading the Kentucky Office of Workers' Claims, and the members of AIK Comp, AIK Comp has been damaged in an amount to be proven at trial.

COUNT II – NEGLIGENCE AGAINST MEYER

34. Plaintiff states, reiterates and incorporates herein by reference each of the preceding paragraphs of this Complaint.

35. Meyer provided professional services to AIK Comp in the course of his business to provide accurate and reliable auditing advice and professional services to AIK Comp.

36. Meyer received compensation and/or remuneration for those services provided to AIK Comp.

37. Meyer violated applicable auditing standards and was otherwise negligent in auditing AIK Comp's financial statements by overlooking, ignoring, or failing to consider historical data, loss trends, and current events and by further accepting actuarial assumptions and conclusions that it knew or should have known were erroneous.

38. Meyer owed a duty of care and prudence to AIK Comp in performing his audits in accordance with GAAS and accepted industry standards to make sure that the statements of financial condition that he

certified for AIK Comp were in accordance with GAAP and accepted industry standards. Meyer failed to exercise the care and prudence that he owed to AIK Comp, and his failure to exercise the care and prudence that he owed AIK Comp was a substantial factor in causing AIK Comp to suffer losses and other damages in an amount to be proven at trial.

39. Meyer's negligence in auditing AIK Comp's financial statements misled the Kentucky Office of Workers' Claims with respect to the financial condition of AIK Comp. As a result, remedial or other regulatory actions which could have been taken to salvage and save AIK Comp, thereby reducing the costs of assessment and rehabilitation incurred once AIK Comp was placed into rehabilitation, were not taken.

40. Upon information and belief, Meyer regularly audits the financial statements of insurers regulated by various regulatory agencies in the Commonwealth of Kentucky and other states. Accordingly, Meyer knew or should have known that the information contained in the audited financial statements was misleading, deceptive, and/or inaccurate.

41. As a result of Meyer's negligence as described above in misleading the Kentucky Office of Workers' Claims, and the members of AIK Comp, AIK Comp has been damaged in an amount to be proven at trial.

COUNT III – NEGLIGENT MISREPRESENTATION AGAINST E&Y

42. Plaintiff states, reiterates and incorporates herein by reference each of the preceding paragraphs of this Complaint.

43. E&Y owed AIK Comp a duty, inter alia, to ensure that its audits complied with GAAS and accepted industry standards.

44. E&Y breached this duty by negligently making false and misleading statements and omissions upon which AIK Comp directly or indirectly relied, and which reliance resulted in significant economic losses.

45. As a result of E&Y's negligent misrepresentation, AIK Comp has been damaged in an amount to be proven at trial.

COUNT IV – NEGLIGENT MISREPRESENTATION AGAINST MEYER

46. Plaintiff states, reiterates and incorporates herein by reference each of the preceding paragraphs of this Complaint.

47. Meyer owed AIK Comp a duty, inter alia, to ensure that his audits complied with GAAS and accepted industry standards.

48. Meyer breached this duty by negligently making false and misleading statements and omissions upon which AIK Comp directly or indirectly

relied, and which reliance resulted in significant economic losses.

49. As a result of Meyer's negligent misrepresentation, AIK Comp has been damaged in an amount to be proven at trial.

COUNT V – NEGLIGENCE AGAINST LATTANZIO AND A&T

50. Plaintiff reiterates, restates and incorporates by reference all of the allegations contained in the preceding paragraphs of this Complaint.

51. Lattanzio and A&T provided actuarial and other services to AIK Comp, including, but not necessarily limited to, premium rate studies and recommendations about the adequacy of premiums. Lattanzio and A&T received compensation and/or remuneration for the services provided to AIK Comp.

52. Lattanzio and A&T were negligent in providing actuarial opinions and reserve studies to support the financial statements of AIK Comp for the years 1997 through 2002.

53. Lattanzio and A&T were contractually and professionally required to exercise care and prudence in the preparation of the reserve studies and the actuarial opinions to support the financial statements. Lattanzio and A&T failed to exercise the care and prudence their contract and profession required of them and, as a result, was a substantial factor in causing AIK Comp to suffer damages in an amount to be proven at trial.

54. Lattanzio and A&T knew or should have known that the claims incurred would be greater than they had estimated and, as a consequence, the loss reserves should have been much higher than were established.

55. The failure by Lattanzio and A&T to properly estimate claims and set loss reserves caused AIK Comp to misstate its financial condition to the Kentucky Office of Workers' Claims, the public, and to AIK Comp's members. The misleading financial statements to which A&T and Lattanzio contributed caused a delay in remediation or other remedial efforts that could have reduced the assessments required of AIK Comp members and stalled, and perhaps prevented, the need for rehabilitation and its associated costs.

56. As a result of Lattanzio's and A&T's negligence, AIK Comp has suffered damages in an amount to be proven at trial.

WHEREFORE, Plaintiff demands as follows:

1. Judgment against Defendants jointly and severally for monetary damages in an amount in excess of this Court's jurisdictional limits;

2. any and all equitable relief to which AIK Comp may appear properly entitled;

2. attorneys' fees and all costs herein expended;

3. all appropriate interest;

4. trial by jury on all issues so triable; and,

5. all further relief to which AIK Comp may appear entitled.

Respectfully submitted,

/s/ Walter L. Sales
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(502) 582-1601
Counsel for Plantiff

VERIFICATION

STATE OF KENTUCKY
COUNTY OF FRANKLIN

I, Martin J. Koetters, Executive Director Kentucky Office of Insurance as Rehabilitator of AIK Comp, for and on behalf of AIK Comp, hereby verifies that the factual allegations set forth in the foregoing Complaint are to the best of my knowledge true and correct.

/s/ Martin J. Koetters March 28, , 2005
Martin J. Koetters, Executive Director
Kentucky Office of Insurance as
Rehabilitator of AIK Comp, for
and on behalf of AIK Comp,
Affiant

SWORN to and SUBSCRIBED before me this 28 day of March, 2005.

My commission expires: 10-28-06.

/s/ Jeff Henderson
NOTARY PUBLIC, STATE AT LARGE, KY

APPENDIX C

Ky. Rev. Stat. Ann. § 304.33-150 Rehabilitation orders.

(1) Appointment of rehabilitator. An order to rehabilitate the business of a domestic insurer, or an alien insurer domiciled in this state, shall appoint the commissioner and his or her successors in office rehabilitator and shall direct the rehabilitator forthwith to take possession of the assets of the insurer and to administer them under the orders of the court. The filing or recording of the order with any county clerk in the state shall impart the same notice as a deed, bill of sale, or other evidence of title duly filed or recorded with that county clerk.

(2) Any order issued under this section shall require accountings to the court by the rehabilitator. Accountings shall be at such intervals as the court specifies in its order, but no less frequently than semiannually. Each accounting shall include a report concerning the rehabilitator's opinion as to the likelihood that a plan under KRS 304.33-160(5) will be prepared by the rehabilitator and the timetable for doing so.

(3) Anticipatory breach. Entry of an order of rehabilitation shall not constitute an anticipatory breach of any contracts of the insurer, and it shall not be grounds for

revocation or cancellation of any contracts of the insurer.

Ky. Rev. Stat. Ann. § 304.50-110 Statement of financial condition -- Contents.

(1) In addition to reports required under KRS 304.50-060, each workers' compensation self-insured group shall file with the commissioner an annual statement of financial condition audited by an independent certified public accountant on or before one hundred and twenty (120) days from the end of the group's fiscal year for the immediately preceding fiscal year. The annual financial statement shall be on a form approved by the commissioner and in accordance with generally accepted accounting principles.

(2) The annual financial statement shall include actuarially appropriate reserves for:

(a) Known claims and expenses related to such claims;

(b) Claims incurred but not reported and any expenses associated such claims; and

(c) Unearned premiums, contributions, and assessments.

(3) The annual financial statement shall also include an actuarial opinion by a qualified actuary and a supporting reserve study regarding reserves for known claims and expenses associated with such claims. The

reserve study shall include documentation sufficient for another actuary practicing in the same field to evaluate the work. The documentation shall describe clearly the sources of data, material assumptions, and methods.

(4) The following statements shall be included with the annual financial statement:

(a) Balance sheet;

(b) Statement of gain or loss from operations;

(c) Statement of changes in financial position; and

(d) Notes to financial statements required by generally accepted accounting principles, which shall include a narrative explanation of all material transactions and balances of the self-insured group.

(5) No person shall make a deceptive statement or fail to correct a misstatement in connection with the solicitation of membership of a self-insured group.